# 2011 CALIFORNIA POLICY OPTIONS

UCLA School of Public Affairs

The Ralph and Goldy Lewis Center

# 2011

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# POLICY

# OPTIONS

## EDITED BY DANIEL J.B. MITCHELL

UCLA School of Public Affairs
The Ralph and Goldy Lewis Center

California Policy Options 2011



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# PREFACE

This annual collection of writings produced by The Ralph and Goldy Lewis Center in the UCLA School of Public Affairs gives readers a critical perspective on the current public policies, economy, and political climate of the State of California.

Each year, *California Policy Options* serves as a time capsule of sorts, capturing a cross-section of voices on the issues of the day; providing an unflinching assessment of the measures the State has undertaken to address its fiscal, political, and planning issues; the ramifications of the programs and legislation that have been implemented; and alternative proposals that could prove to be viable solutions to California's problems.

Addressing the interrelated challenges of the political process, economics, and policy unique to our state, this annual volume exemplifies the strength of the UCLA School of Public Affairs as a nexus of thought-provoking new ideas that transcend disciplinary boundaries.

Many thanks go to Professor Daniel J.B. Mitchell for editing a volume that is both timely and provocative; giving a broad perspective on the historical policy decisions that led to our current situation; and pointing to ideas for creating a better future.

**Franklin D. Gilliam, Jr.**
Dean
UCLA School of Public Affairs

# INTRODUCTION

This edition of *California Policy Options* arrives in a period of economic hard times and political uncertainty. California faces immediate problems related to the results of the Great Recession. The state budget has been in a difficult condition for several years and the outlook is for continued fiscal distress. Residents of the state are harmed by a very soft labor market. The state faces the challenge of a gridlocked political system which hinders its ability to address longer-term problems such as the nature of its tax system or the support of public higher education.

While California has been in the forefront of environmental policy, the degree to which environmental goals can be achieved is often questioned. Commentators concerned with the state's business climate are often among those raising such questions. All of these issues are addressed in this volume.

## THE ECONOMY

Chapter 3 by Christopher Thornberg, Jon Haveman, and Jordan G. Levine provides an economic forecast for California. The authors believe a "double-dip" recession is unlikely in the state and that the outlook is for a continued recovery, but a very slow one. Unemployment—over 12% in 2010—does not seem likely to dip below 10% until 2012. As Lauren D. Appelbaum points out in Chapter 6, California has fared worse than most other states in the job market. During the recessions of 1990 and 2001, California also had a more severe and prolonged slump than the rest of the U.S. During the current slump, as in the past, Latinos and African Americans have been particularly hard hit as have individuals with limited educations.

Whenever the economy turns down and jobs become scarce, the business climate and California's "competitiveness" (or lack thereof) become a longer-term concern of public policy. In chapter 7, Jerry Nickelsburg and Robert Spich take a look at that question. Usually, the competitiveness issue is put in terms of California job loss to other states or countries. In their chapter, however, Nickelsburg and Spich draw insights from both economics and management.

California's past competitiveness was based on such inherent factors as its location as well as investments in education and infrastructure. While the inherent endowments do not change, the authors caution that these other aspects of the state's competitiveness are always at risk. They are concerned about a tendency in California public policy to exhibit *ad hoc* and piecemeal decisions. Uncertainty and volatility of policy do not foster state competitiveness.

## FISCAL AFFAIRS

Chapter 1 by Daniel J.B. Mitchell provides a description and analysis of attempts to deal with an ongoing state budget crisis whose roots go back before the Great Recession. The starting point in Mitchell's tale of fiscal distress begins with the May 2009 rejection by voters of various ballot propositions that would have extended the duration of tax increases. While the governor and the legislature did react to the economic slump by paring spending, the end product of the state's very late adoption of a budget for 2010-11 was to leave a major budget crisis/legacy for Governor-elect Jerry Brown. Not surprisingly, Brown has warned of difficult decisions ahead.

One of the areas in which spending has been cut has been public higher education. In Chapter 5, former UCLA Chancellor Charles Young looks at the question of financing the University of California. He notes that the concept of free tuition embodied in the Master Plan of 1960 was already serious eroding by the 1970s. Proposition 13 of 1978 drastically cut local property taxes and left local government and school districts dependent on state aid. It also required a two-thirds vote for tax increases. These pressures for limited state dollars competed with state support for higher education. Given the current fiscal outlook and the likelihood of continued stringency, Young points to a model of self sufficiency for the UC system. Such a model would entail higher tuition, more student aid, and a multi-year contractual partnership with the state.

A key element of a fiscal system is its tax side. The tax side involves not just the aggregate flow of revenue but also the particular taxes that contribute to that inflow. Kirk Stark in chapter 8 notes that the state created an entity to examine its tax system, the Commission on the Twenty-first Century Economy. In 2009, COTCE did come up with a package of recommended changes—big changes—in the system. Among other recommendations, the package included a type of "value added" tax. But its package ultimately went nowhere.

Part of the reason for the failure involved constraints on the Commission's mission. Among them was a decision not to reconsider aspects of Proposition 13 despite that initiative's major role in California's fiscal affairs. But the administrative and legal complications entailed in the new tax proposal also played a major role in COTCE's ultimate failure. Key members of the Commission seemed oblivious to the implications of such constraints and complications. Thus, California lost an opportunity for fiscal reform.

## ENVIRONMENT

California's environmental rules—including its interest in alternative energy and reducing greenhouse gas emissions—are often criticized as potentially costly. However, voters and elected officials have shown continued support for these rules, even in the face of the Great Recession. For example, voters rejected suspension of a key environmental law that was offered to them on the November 2010 ballot.

In chapter 4, Max Messervy analyzes California's 2007 Low Carbon Fuel Standard. The rules he describes potentially affect transportation (driving) and fuel production. Under the rules, calculation of the emissions produced involves not just immediate emissions but an analysis of the entire supply chain.

One element of California's environmental enthusiasm has been the idea that the state could be a pioneer in developing "green" industries. In this view, environmentalism is seen as a route to job creation, not destruction. As chapter 9 by Kristina Bedrossian, Sarah Locher, Frank Lopez, and Matthew O'Keefe points out, the City of Los Angeles hopes to capture some of this potential job development. Specifically, it has been developing a plan to induce "clean tech" companies to locate within the City.

The authors identify a variety of aspects of the City that could be advantages or disadvantages in attracting clean tech jobs. For example, they note a lack

of training for workers as a potential disadvantage. On the other hand, the availability of the seaports and airport is a plus factor. Fostering clean tech industry clusters is seen as an important goal for the City.

## POLITICS

It may well be that the key to California's success or failure over the long haul in dealing with its economic and job problems, its fiscal dilemma, and its environmental objectives, is the degree to which its political system can be freed from its infamous gridlock. In chapter 2, William Parent—using zoological labeling—finds the California electorate to be divided into two primary groups (and a variety of subgroups within them). Because these groups are often divided by region, it has proved difficult in recent years to find centrists in the legislature who can reach compromises. However, changes may be coming thanks to voter-approved nonpartisan primaries and redistricting.

Exactly how those reforms will play out is unclear. But Parent ends with a hopeful observation. He points to the polarizing effects of the Great Depression on California in the 1930s, but notes that it proved nonetheless politically possible to produce major infrastructure projects. Included among these noteworthy projects were the Bay Bridge and the major aqueduct bringing water from the Colorado River to southern California. These achievements might yet be repeated *if* California can put its political institutions in order.

**Daniel J.B. Mitchell**
Professor Emeritus
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# 1

# GOVERNMENT BY (HOT) CHECKS AND (IM)BALANCES:

## CALIFORNIA'S STATE BUDGET FROM THE MAY 2009 VOTER REJECTION TO THE OCTOBER 2010 BUDGET DEAL


## DANIEL J.B. MITCHELL

Professor Emeritus, UCLA Anderson Graduate School of Management and UCLA School of Public Affairs.


This chapter was completed in late October 2010 and contains information only up to that date.

# 1

*"We don't have to worry about going off the cliff; we're already there."*

—state senator Bob Dutton
vice chair of the Senate Budget Committee[1]

*"…California has defied its prophets of doom before, recreating and renewing itself.…I hope it does so again — for the country's sake as well as California's. But I have my doubts."*

—John B. Judis, senior editor for *The New Republic*[2]

In prior editions of *California Policy Options*, as well as other publications, I have traced the travails of the California budget during the first decade of the 21st century. That period was noteworthy because of the 2003 recall election and the replacement of incumbent Governor Gray Davis by Arnold Schwarzenegger. In the 2010 edition of *California Policy Options*, I noted the contrasting personalities of those two governors and the paradoxical fact that despite the contrasts, both personality types led to a similar result.

Davis, the micro-manager, tended to be overextended to the point that warnings of crisis (in his case, electricity deregulation and budget) were ignored until events overwhelmed him. Schwarzenegger, who as governor loved championing "big picture" causes but was unconcerned about details, also missed warning signs. (In his case, the signs were the darkening budget outlook and its implications for his universal state health care proposal until it was too late.) As it turns out, too much micro-management and too much macro-management lead to unfortunate consequences.

In chapters in earlier *California Policy Options* editions, I also drew lessons from gubernatorial administrations that predated the Davis-Schwarzenegger era. Surprisingly, the governor most like Schwarzenegger in his appetite for both "big picture" identification and celebrity attention was Jerry Brown, first elected in 1978 and a renewed candidate for governor in 2010. Brown missed the growing momentum behind Proposition 13. In fact, he inadvertently contributed

to that momentum by building a huge state reserve at a time that property taxes were zipping upward. As a result, Brown ended his second term leaving a major fiscal crisis to his successor, George Deukmejian. In turn, Deukmejian—reelected in 1986 on a record of turning around state finances—left a major fiscal crisis at the end of two terms to his successor, Pete Wilson.

The fact that California's budget has had its ups and downs despite varying gubernatorial leadership styles and varying political institutions has led some observers to view the state's budgetary problems as simply a reflection of the national business cycle. After all, other states' fiscal problems have also corresponded to the business cycle. But across these states there are different institutions and political personalities.

In that view, California's famed dysfunction is just a matter of the state's size and prominence. It is no more dysfunctional than lower profile states; it is just noticed more. But while the national business cycle is obviously a key element in the fiscal problems of all state and local governments, California sported the lowest bond rating among the states in 2010. Only California handed out registered warrants (IOUs) rather than pay all its bills in 2009. While the business cycle poses similar challenges to all states, there is differentiation when it comes to the ability to make needed decisions to cope with those challenges. Some of California's inability to make necessary decisions on the budget quickly comes from institutional arrangements in the state. But in the background is the painful reality that California has yet to internalize the transition after 1990 from a state economy that had been given a federal push during three hot wars and the Cold War.

## UNDERLYING CAUSES

*"I don't think we have enough time to tell you the amount of things I didn't know, because there is no school for governors."*

—Governor Arnold Schwarzenegger asked in 2010 about what he knew about governing when elected in the 2003 recall [3]

*"Whenever we have a problem, everyone makes a big drama — 'Oh, my God, it's the end. California is over.' It's all bogus."*

—Governor Arnold Schwarzenegger [4]

In last year's budget chapter in *California Policy Options* I argued that there is indeed an underlying cause of California's fiscal dysfunction but that it goes beyond the business cycle. Most importantly, California's economic growth has two important inflection points. California underwent a notable growth acceleration after 1940 and a major deceleration in 1990s. The first date (1940) corresponds to the military expansion sparked by World War II and then continued by the Cold War (along with the Korean and Vietnam hot wars).

Military-related expenditures fueled state growth which in turn contributed to ongoing tax revenues that could be used for infrastructure construction (roads, water projects) as well as schools and higher education facilities. But rapid population growth eventually sparked environmental sensitivities and resistance to density pressures, a formula for rising property values. The resulting escalation of property taxes gave rise to Prop 13 and the accompanying tax revolt in 1978.

The second inflection point (1990) marked the end of the Cold War. It left California's with a more normal growth trend relative to the rest of the U.S. But California had a legacy of expectations for public services built on the earlier super-normal growth path. At the same time, the

tax revolt had limited the public's willingness to divert income to pay for such services.

Despite being a center of the dot-com boom of the late 1990s and then the housing/mortgage boom of the 2000s, California—even at the peaks of those booms—never get back to its old growth path. And the mismatch of expectations for services based on super-normal growth and tax receipts based on normal growth has led to repeated crises. During boom periods, the added tax receipts tend to be sucked into ongoing programs rather than put aside for "rainy days." During slumps, what fiscal experts term the state's "structural" deficit quickly turns into a crisis. The most recent such crisis began to develop in fiscal year 2006-07.

Because other states have experienced budgetary problems in the latest economic slump, and because each state has different institutions, some observers have argued that the usual suspects in California—ballot-box budgeting, term limits, the two-thirds vote rules for passing budgets and taxes, Proposition 13 of 1978, dependence on the volatile state income tax, gerrymandered districts, etc.—are not the culprits. That is a mistake. What matters in California is the above-mentioned post-Cold War inflection *combined with* the usual suspects.

All states will experience negative budgetary consequences of a general downturn. But what is important is their ability—in the face of a downturn—to make decisions and rapid adjustments. States do not have the federal government's seeming ability to run large deficits over prolonged periods without consequences. Different states may have different institutions that either aid or impede such decisions and adjustments. California has developed a system that impedes.

California combines its structural deficit problem with a sequence of unintended consequences. Its direct democracy has become self-reinforcing. Governors may decry ballot-box budgeting. But as candidates they can (and do) benefit by endorsing ballot initiatives.[5] Arnold Schwarzenegger himself began his political career in 2002 by promoting Prop 49, earmarking a portion of the General Fund by formula to after-school activities.[6] Governors—including Schwarzenegger—are tempted to take budgetary issues to the people directly when they become frustrated with the legislature.

Prop 13's political effects in many respects were more important than its cut in property taxes. It gave rise to an industry of ballot initiative pushers. In its wake, voters passed the so-called Gann Limit as part of the taxpayer revolt. Gann triggered tax rebates in the late 1980s. That development led the California Teachers Association and the education establishment successfully to enact Prop 98 in 1988 and a subsequent initiative which by complex formulas gutted Gann and channeled roughly 40% of the General Fund to K-14 education.[7]

Direct democracy was adopted by Californians in 1911 as an alternative form of lawmaking. It is inherently a process that weakens the authority of the legislature. Indeed, it was enacted precisely because early 20th century reformers viewed the state legislature as corrupt. The problem is that a weakened legislature, particularly one constrained by formulas and rules, is a slow deliberator. Frustration over legislative inaction leads to further voter weakening of the legislature, notably the adoption of term limits in 1990. But a legislature composed of amateurs and members focused on their next political office is not effective in dealing with crises. The result is more public frustration with the legislature.

Gubernatorial candidates will naturally promise to fix the problems of the state but their proposed fixes often require legislative action. A weak legislature thus leads to weak governors and more public disappointment and frustration with their chief executive. Governors can't always deliver what they promise—particularly

if they promise too much. Moreover, any realistic fixes necessarily involve unpleasant trade-offs.

For example, do you want to have a less volatile tax base for California? Then you must shift from heavy reliance on income and corporate taxes toward the less-volatile sales tax in some form. But if you do, you will make the tax system more regressive. You can try to disguise that impact. That approach was taken by the Commission on the 21st Century Economy appointed by the governor and legislature tried to do, by proposing to substitute a variant of a European-style value-added tax.[8] But such a tax, in the end, is a complicated sales tax. Not surprisingly, the Commission's recommendation is now buried in the state archives.

Reports that came out after the Commission's recommendations suggested that the proposal of a value-added variant was a pet project of the Commission chair.[9] In keeping with California's progressive tradition, the Commission was chaired by someone who did not hold elective office. As a result, the Commission's final document was a political nonstarter; it was dead on arrival. But even a more practical set of recommendations would have involved unpleasant trade-offs.

## RECAP: THE BUDGET STORY IN THE SCHWARZENEGGER ERA

*"California, it has long been claimed, is where the future happens first. But is that still true? If it is, God help America."*

—columnist and Princeton professor Paul Krugman[10]

*"People have been declaring this place on the brink of extinction for decades."*

—San Francisco mayor Gavin Newsom, comment on California when he was a candidate for governor [11]

Governor Schwarzenegger's priorities after he was first elected in 2003 shifted on an annual basis. Immediately after the 2003 recall and into 2004, the focus was on the state budget crisis left by predecessor Gray Davis. By that time, the California economy and budget situation was improving. However, a large short-term debt had accumulated under Davis which had to be rolled over regularly and at high interest rates.

Essentially, Governor Schwarzenegger adopted the plan that Davis had been proposing of refinancing the short-term debt on a long-term basis. Under the state constitution, borrowing long-term requires a popular vote. Moreover, such borrowing is not supposed to take place to finance ongoing state operations; rather, it was reserved for one-time infrastructure-type projects.

Davis had proposed a legally-questionable process to skirt these constitutional requirements but this avoidance would probably have undermined the plan in practice. It was hard to see how a long-term refinancing bond could be successfully floated, given the legal cloud. Who would buy a bond whose issuance might be ruled

illegal by a subsequent court decision? In such an event, the bond might be worthless, even if the state had the ability to make the contracted payments.

Schwarzenegger, taking advantage of his post-recall popularity, proposed two voter propositions aimed at approving the borrowing and amending the constitution to allow a one-time exception to the rule about ongoing operations. Sold as a bipartisan and unique fix—after which the state would "throw away the credit card" —his propositions 57 and 58 were approved in 2004. With the Davis budget debt legacy out of the way, Schwarzenegger could focus on other matters.

In 2005, Governor Schwarzenegger promoted a series of initiatives in a special election he called as part of what was dubbed the "Year of Reform." Of four initiatives that ended up on the ballot, two seemed aimed at public-sector workers and unions, especially teachers. Only one dealt with the budget. A third proposed a process for neutral redistricting.

The four propositions of 2005 never seemed to be a coherent package. Indeed, the process of drafting them suggested that the governor just wanted to enact "reforms," regardless of specific content. The upshot was that vast amounts were spent—especially on TV ads—pushing the pro and con sides in a special election—with the con side raising substantial monies.[12] Ultimately, all four initiatives were soundly defeated. At the same time, the governor's popularity tanked. The public preferred the image of the cooperative governor working with the legislature to deal with the Davis debt legacy to the combative governor seeking to circumvent the legislature with diverse ballot propositions.

Faced with the 2006 gubernatorial election year, Governor Schwarzenegger switched from reform to infrastructure, albeit infrastructure to be financed by borrowing. The idea of reducing traffic congestion at no (immediate) cost carried the day and roughly $40 billion in bonds were authorized. The governor apologized to voters in his January 2006 State of the State address for the controversy he had created over his 2005 reform initiatives. There had been a "message received" from the voters, he proclaimed, and henceforth he would work with the legislature to solve California's problems. With the economy improving and the appeal of new infrastructure, Schwarzenegger won reelection handily over Democrat Phil Angelides, the state treasurer.

In 2007, the governor's centerpiece became a state universal health care plan, modeled loosely after a plan previously adopted in Massachusetts (and which became the general model for the Obama plan of 2009-10). However, having tossed the general idea of a state health plan to the legislature, the governor became involved in other environmental issues, even to the point of addressing the U.N. The health care plan did not take serious legislative form, i.e., a bill endorsed by the governor, until late 2007.

By that time, the state budget situation was deteriorating and the economy was weakening. In fact, the Legislative Analyst's Office put the start of the Great Recession in California in the third quarter of 2007, somewhat ahead of the official dating of the slump for the U.S. as a whole.[13] The plan passed in the state Assembly but, despite a celebration following its lower-house passage, the governor's health agenda was derailed in the Senate in early 2008 over budget concerns. From then on, the budget became the overwhelming issue in California.

A stalemate of (then) record duration left the state without a budget from July 1, 2008 until late September. At that point, a budget was passed but one widely known to be unsustainable. The result was a required mid-course redo of the 2008-09 budget in February 2009, combined with a new budget for the 2009-10 fiscal year.

Budgets and tax increases in California required a two-thirds vote in legislature and the Democrats had a majority—but not two-thirds in both houses.[14]

Eventually a deal was struck with a few Republicans thus allowing temporary increases in income, sales, and car taxes.[15] The Republican leaders in both houses were soon deposed by their GOP colleagues for making this accommodation.

In addition, a major recall effort was unsuccessfully mounted against an accommodating Republican assemblyman from southern California. Despite the formal failure of the recall, he chose not to run for reelection.[16] The only accommodating Republican who gained anything was state senator Abel Maldonado. He was nominated by the governor to fill a vacancy in the lieutenant governor position and—after a considerable delay and political manipulation—was eventually confirmed. [17]

Part of the February 2009 budget-revision deal involved putting a series of propositions on the ballot in a special election held in May. These ballot measures would allow voters to extend the newly-enacted tax increases beyond their scheduled sunset dates. And, if passed, the ballot propositions would divert otherwise earmarked revenues from mental health and early childhood services into the state's general fund. Borrowing against the state lottery would also have been authorized.

Voters rejected all of the substantive propositions in May 2009. Only one proposition—a meaningless slap at the legislature designed to attract support to the others—was enacted. At the same time, the revenue picture for the state continued to deteriorate due to the financial and housing bust/mortgage crisis that had begun to unfold in 2008.

Finally, 2010 was a gubernatorial election year as well as an election year for other state and legislative offices. Governor Schwarzenegger had become a lame duck, reducing what leverage he had in enacting a budget for 2010-11. Candidates began to emerge for the June 2010 primary in both parties.

Only one—Republican gubernatorial candidate Tom Campbell, a former budget director under Schwarzenegger—was willing to talk about a tax increase (the gasoline tax in his case). But Campbell eventually dropped out of the primary race for governor and shifted to the US Senate primary contest (and lost).[18] Attorney General and former governor Jerry Brown did not officially become a Democratic candidate until late in the game. But he suggested—as an unofficial candidate—that he was against tax increases.

More specifically, he indicated he would not propose tax increases *but* allowed that voters might enact them through ballot propositions. That stance suggested that—if elected—he might be planning to take budget-related issues directly to the electorate. Mostly, however, Brown was silent and just let the campaign contributions flow in. Since it became more and more likely that he would be running in the general election against a self-funded billionaire, Meg Whitman, Brown did not want to say anything that would put him at a further disadvantage.

San Francisco Mayor Gavin Newsom, who became a gubernatorial candidate but later shifted to the lieutenant governor race, was not specific about what he would do about the budget. Mainly he hoped that his mayoral record in San Francisco (which included kicking off the gay marriage agenda by marrying couples in City Hall despite state law—and a sense that he was Internet/high-tech savvy) would bring him the nomination. And he succeeded in obtaining the Lieutenant Governor nomination in the June 2010 Democratic primary to run against Maldonado.

Los Angeles mayor Antonio Villaraigosa was reported to be considering running for governor but decided against a run as his city's own budget situation deteriorated. Republican businesswoman Meg Whitman and insurance commissioner Steve Poizner—the surviving GOP candidates in the primary after

Campbell departed—focused initially on cutting state government employment. But much of what the state does is pass money to local governments so that large savings could not come from trimming that part of the state bureaucracy supported by the General Fund. Later, both Republicans came out with more detailed plans, neither of which involved tax increases. And much of their primary contest revolved around social issues such as immigration and gun rights.

As the victor in the Republican primary, Whitman softened her stance on immigration—provoking anger on the right. She was berated by Los Angeles AM radio hosts "John and Ken" for a seeming betrayal of the primary voters. But by that time, she was the candidate. The immigration issue resurfaced a few weeks before the general election when a former illegal immigrant housekeeper filed a claim against Whitman. Ostensibly, the claim involved a little over $6,000 in back pay. However, the main element of "housekeeper-gate" involved the longtime employment of the woman involved and a subsequent seemingly unfeeling firing.[19]

Whitman continued to spend generously on her campaign demonstrating a willingness to spend that suggested a ballot-box strategy for her program if she won. That is, since her positions on the budget and other matters would likely not win the favor of a majority in the legislature, she could finance an initiative campaign. While that possibility evoked memories of Governor Schwarzenegger's failed "Year of Reform" campaign in 2005, presumably she could outspend opponents in such a contest.

# RECAP: THE NUMBERS

*"We have been put through a stress test right now, and we have failed."*

—Governor Arnold Schwarzenegger on The Tonight Show with Jay Leno [20]

*"Californians deserve a better system of governance, and this one is a failure… There has to be a better way…"*

—Jim Wunderland, president of the Bay Area Council calling for a Constitutional Convention [21]

**Charts 1, 2**, and **3** summarize the inflows and outflows to the General Fund from the late 1990s through the fiscal year ended June 30, 2010. Cash flow reports, available from the state controller, reflect the after-the-fact outcomes of budgets as opposed to budget projections and forecasts made when budgets were proposed or enacted. However, like budget documents, the cash flow reports tend to treat borrowing as revenue and saving as expenditure. **Chart 1** shows the officially reported receipts and disbursements. **Chart 2** makes a crude adjustment by removing transfers in and out of funds outside the General Fund. Such transfers often reflect borrowing and saving. **Chart 3** directly compares surpluses and deficits on the official and adjusted basis.

The official numbers are especially clouded by the electricity crisis of the early 2000s which led the state to buy electricity for its bankrupt and semi-bankrupt private utilities. Initially, the General Fund bore the expense but it was ultimately reimbursed by a bond issue (paid for by utility consumers). The adjusted figures show the deficit at the peak of the business cycle during fiscal year 2000-01. They also show the budgetary recovery that was underway at the time of the 2003 recall. The worsening budget situation that was developing in 2006-07 is also apparent.

**Chart 1. California General Fund: Official Cash Flows Fiscal Years Ending June 30**

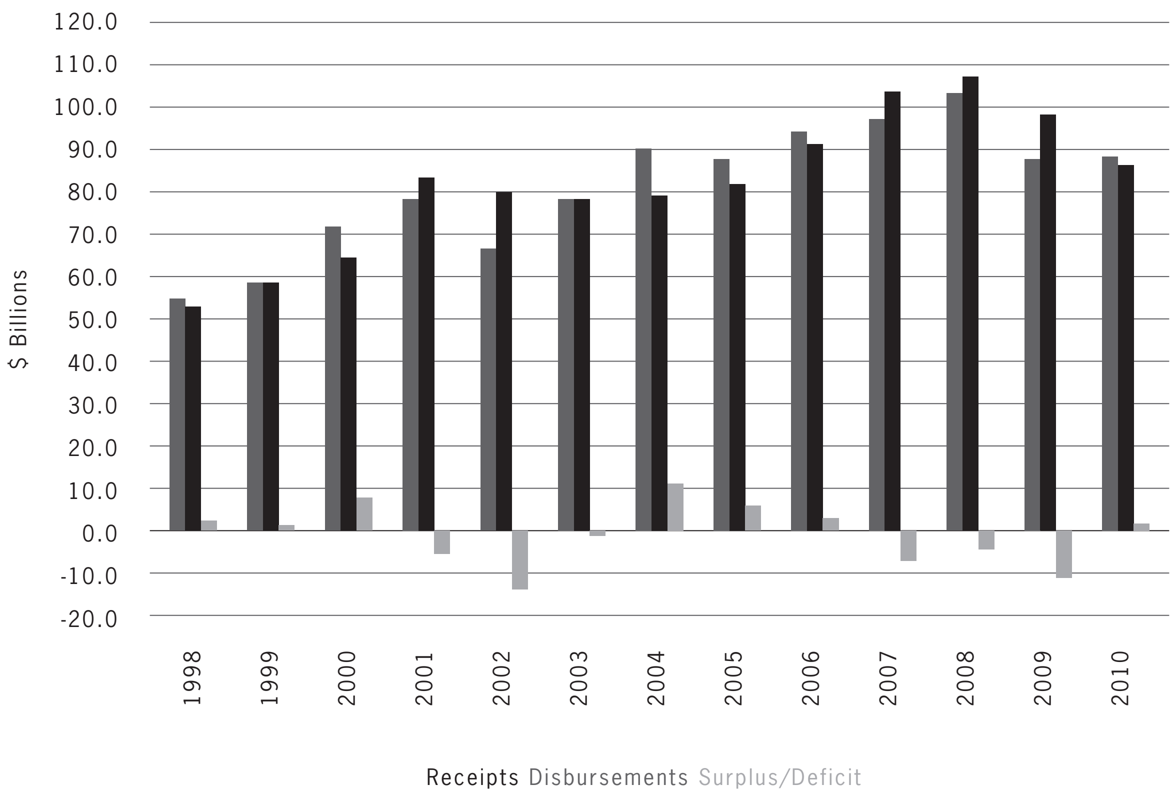
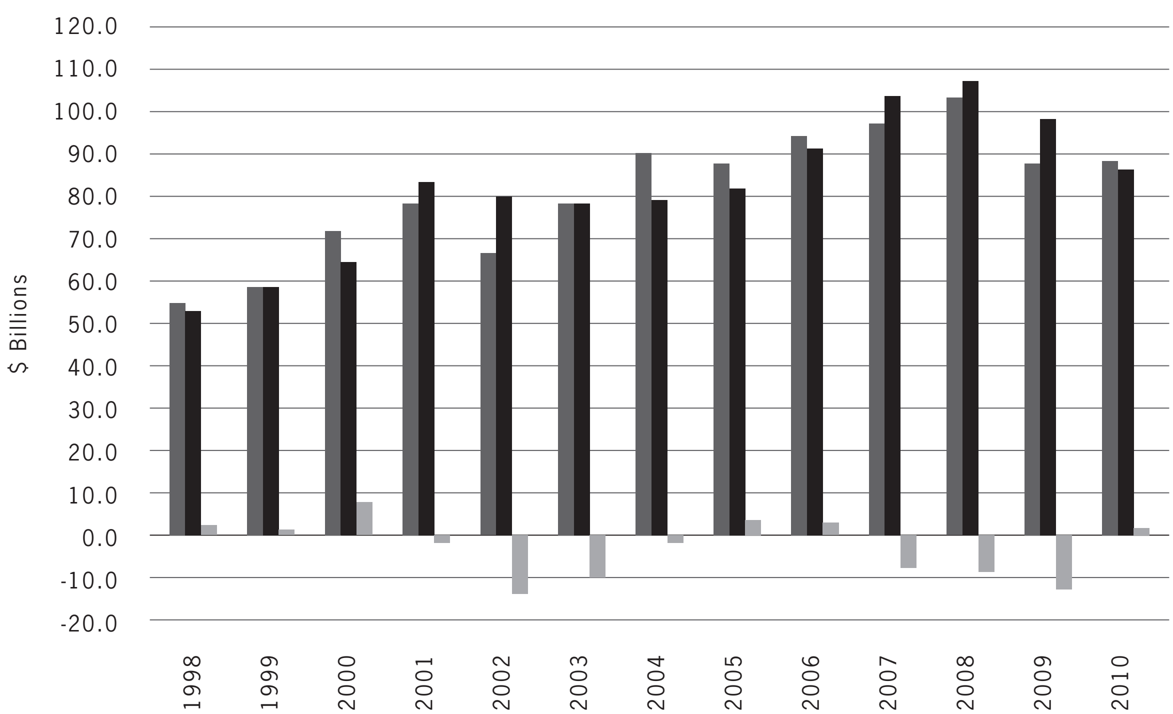
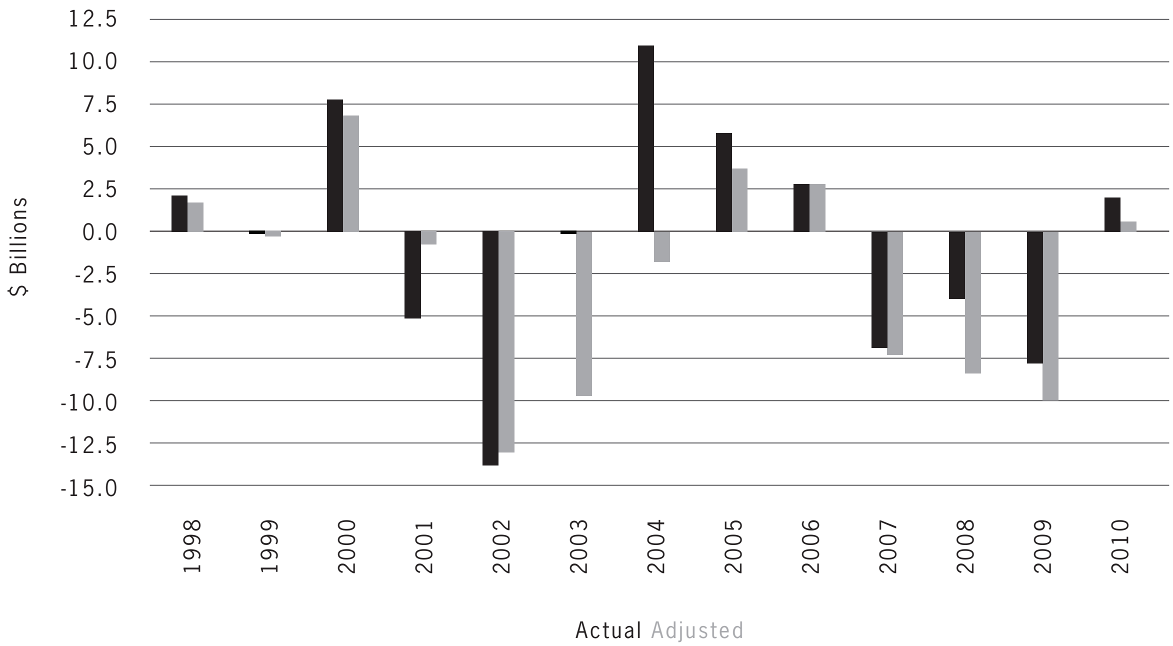



**Chart 2. California General Fund: Adjusted Cash Flows Fiscal Years Ending June 30**




Source of Charts: June monthly cash statements of the California State Controller.

**Chart 3. California General Fund Official vs. Adjusted Surplus or Deficit: Fiscal Years Ending June 30**




Source: June monthly cash statements of the California State Controller.

A combination of spending cuts and temporary tax increases, as well as a variety of one-time borrowings and diversions from other funds, improved the fiscal condition of the General Fund in 2009-10. However, the tendency of "workload" expenditures to rise and the playing out of one-time solutions created difficult challenge for 2010-11. Moreover, the voter rejection of the revenue generating elements in the special election of May 2009 made it unlikely that the electorate would come to the rescue with more taxes in 2010-11.

As **Tables 1** and **2** show, Governor Schwarzenegger's popularity ratings have risen and fallen with the budget situation. Indeed, the governor he most resembles in that regard is his predecessor Gray Davis, who he replaced in the 2003 recall. Both Davis and Schwarzenegger started with highly favorable ratings and ended as unpopular. The main difference is that Schwarzenegger had a notable dip during his ill-fated "Year of Reform" in 2005. Davis' favorable ratings followed an inverted U pattern.

By late November 2009, Governor Schwarzenegger was booed when he appeared at Hollywood Park racetrack to honor a winning horse. The irony was that Schwarzenegger remained popular in 49 of the 50 states, California being the exception. He remained a sought-after national TV guest. In late April 2010 on *The Tonight Show with Jay Leno*, the governor said that "without a doubt" he would like to run for president were it not for his constitutional ineligibility due to foreign birth.[22] Governor Schwarzenegger also used the Leno show to announce his above-mentioned nomination of Abel Maldonado for lieutenant governor. These TV appearances suggest Schwarzenegger's continued national popularity outside California.

**Table 1. Trend of Arnold Schwarzenegger's overall job performance as governor (among registered voters)**

| | Approve | Disapprove | No opinion |
|---|---|---|---|
| **September 2010** | **23%** | **68** | **9** |
| July 2010 | 22% | 70 | 8 |
| March 2010 | 23% | 71 | 6 |
| January 2010 | 27% | 64 | 9 |
| October 2009 | 27% | 65 | 8 |
| Late-April 2009 | 33% | 55 | 12 |
| March 2009 | 38% | 54 | 8 |
| September 2008 | 38% | 52 | 10 |
| July 2008 | 40% | 46 | 14 |
| May 2008 | 41% | 48 | 11 |
| December 2007 | 60% | 31 | 9 |
| October 2007 | 56% | 32 | 12 |
| August 2007 | 57% | 31 | 12 |
| March 2007 | 60% | 29 | 11 |
| September 2006 | 48% | 37 | 15 |
| July 2006 | 49% | 40 | 11 |
| May 2006 | 41% | 46 | 13 |
| April 2006 | 39% | 47 | 14 |
| February 2006 | 40% | 49 | 11 |
| October 2005 | 37% | 56 | 7 |
| August 2005 | 36% | 52 | 12 |
| June 2005 | 37% | 53 | 10 |
| February 2005 | 55% | 35 | 10 |
| September 2004 | 65% | 22 | 13 |
| August 2004 | 65% | 22 | 13 |
| May 2004 | 65% | 23 | 12 |
| February 2004 | 56% | 26 | 18 |
| January 2004 | 52% | 27 | 21 |
| **Party registration (Sept. 2010)** | | | |
| Democrats | 21% | 71 | 8 |
| Republicans | 23% | 65 | 12 |
| Non-partisans/others | 26% | 67 | 7 |

Source: California Field Poll, http://field.com/fieldpollonline/subscribers/Rls2357.pdf

**Table 2. Comparing Governor Schwarzenegger's lowest and highest approval ratings with his six immediate predecessors**

| | Approve | Disapprove | No opinion |
|---|---|---|---|
| **Schwarzenegger (R)** | | | |
| Lowest – March 2010 | 23% | 71 | 6 |
| Highest – September and August 2004 | 65% | 22 | 13 |
| **Davis (D)** | | | |
| Lowest – August 2003 | 22% | 70 | 8 |
| Highest – February 2000 | 62% | 20 | 18 |
| **Wilson (R)** | | | |
| Lowest – September 1992 | 33% | 63 | 4 |
| Highest – February 1991 | 52% | 27 | 21 |
| **Deukmejian (R)** | | | |
| Lowest – August 1990 | 53% | 45 | 2 |
| Highest – August 1985 | 73% | 24 | 3 |
| **J. Brown (D)** | | | |
| Lowest – April 1980 | 38% | 61 | 1 |
| Highest – March 1976 | 69% | 25 | 6 |
| **Reagan (R)** | | | |
| Lowest – August 1971 | 46% | 52 | 2 |
| Highest – February 1969 | 60% | 33 | 7 |
| **P. Brown (D)** | | | |
| Lowest – October 1961 | 35% | 50 | 15 |
| Highest – June 1959 | 51% | 22 | 27 |

For measures conducted prior to 1994, original surveys used a five-point response scale which was converted to the current two-point approve/disapprove scale for comparative purposes.
(D) denotes Democrat, (R) denotes Republican

Note: Governor Schwarzenegger's rating fluctuated in the 22-23% range during the period March – September 2010. See Table 1.

Source: California Field Poll, http://field.com/fieldpollonline/subscribers/Rls2333.pdf

Bond ratings, of course, are not directly reflective of political popularity but do reflect fiscal conditions. California had low ratings when Davis was recalled in the midst of the budget crisis, experienced a ratings rebound as the budget picture improved, and ended the period shown on **Table 3** roughly with ratings where they were at the recall. By the time voters rejected the substantive budget-related propositions in May 2009, California had the lowest bond ratings of any state.

**Table 3. Ratings of California General Obligation Bonds**

| | Date | Rating |
|---|---|---|
| Fitch | | |
| | April 2010 | A-* |
| | July 2009 | BBB |
| | June 2009 | A- |
| | March 2009 | A |
| | June 2006 | A+ |
| | July 2005 | A |
| | September 2004 | A- |
| | December 2003 | BBB |
| | December 2002 | A |
| Moody's | | |
| | April 2010 | A1* |
| | July 2009 | Baa1 |
| | March 2009 | A2 |
| | May 2006 | A1 |
| | July 2005 | A2 |
| | May 2004 | A3 |
| | December 2003 | Baa1 |
| | August 2003 | A3 |
| Standard & Poors | | |
| | January 2010 | A- |
| | February 2009 | A |
| | May 2006 | A+ |
| | August 2004 | A |
| | July 2003 | BBB |

Source: California State Treasurer, http://www.treasurer.ca.gov/ratings/history.asp

Below, I pick up the budget story from the May 2009 voter rejection through the eventual adoption of a budget—after a record delay—in October 2010.

## AFTERMATH OF THE MAY 2009 ELECTION: VIEW FROM D.C.

*"Obviously the situation in California is serious. There are crises of different proportions in different states and California is obviously at the front of the list."*
—David Axelrod, senior advisor to President Obama [23]

*"…Washington will probably have to intervene sooner or later. There can be no American recovery if California collapses."*
—commentator and Schwarzenegger biographer Joe Mathews [24]

In the initial days after the May 2009 rejection/election, the governor took the position that the electorate (or at least the 28.4% of registered voters who participated)—by turning down the tax extensions and budgetary diversions simply wanted sharp cuts in spending. Various drastic proposals were made such as cutting the length of the school year, cutting children's healthcare, phasing out Cal Grants (for college students), essentially ending state "welfare" (CalWorks), and cuts in prison funding (despite federal court mandates to do the opposite). To the extent that Governor Schwarzenegger was willing to consider new revenue sources, they tended to be controversial, e.g., new offshore oil drilling—a sensitive environmental issue—in exchange for oil lease payments. (Later, after a major off-shore oil spill in the Gulf of Mexico, he dropped that proposal.)

An interesting question, given the unpalatable nature of Governor Schwarzenegger's proposals, was whether he was really trying to draw in federal aid rather than make such cuts. Overall, his reported savings—if all proposals were enacted—would have saved $3.1 billion in the soon-to-end 2008-09 fiscal year, $20.8 billion in 2009-10, and $18.6 billion in 2010-11, relative to a "workload" projection.[25] The cuts in "welfare" type programs such as Medi-Cal would actually cost the state—but not the state *budget*—more in federal matches than they saved.

Some of the proposed solutions involved diverting funds from local governments, leading to outcries from those sources. Apart from the diversions, cuts of the magnitude the governor proposed were sure not to be approved by the legislature. But the cuts did call national attention to the plight of California's budget.

There may well have been a calculation that rather than see sick children cast into the streets in California, the Obama administration would be forced to come to the rescue. After all, in late March 2009, President Obama had made a speech announcing a federal guarantee of repairs on cars purchased from the bailed-out GM and Chrysler corporations. "Your warranty will be safe," he said, "because starting today the United States will stand behind your warranty."[26] Might the President not do the same for holders of California state and local municipal bonds, if not for sick children? Indeed, if there were a problem in the municipal bond market in California, there could be spillover effects to other state and local bonds around the country.[27]

In a normal budget year, the governor provides an initial budget proposal in early January and follows it with the "May revise" proposal, so named because it comes in mid-May. The May revise is an update based on later economic projections and on political developments. However, 2009 was not a normal year.

For one thing, the 2009 May revise was dribbled out in pieces and was itself revised before and after the special election. In addition, a budget ostensibly through June 2010 had been adopted in February, albeit one that was partly linked to the rejected ballot propositions. So there was already a budget technically in place on July 1, 2009. Given the legislature's unusual action in February, the May revise was thus a proposed *modification* of an already-enacted 2009-10 budget rather than a proposal for a wholly *new* one.

The process of a May revise to an enacted budget raised an interesting legal question. To the extent that the legislature adopted the May revise or some other budget revision for 2009-10, it would be amending a budget in place. Normally, the governor has line-item veto powers over a *newly-enacted* budget. In this case, however, would those powers apply to a modification of an *existing* budget?

Initial litigation on that point favored the governor and, much later, a state Supreme Court decision approved the line-item vetoes he eventually made in the amended budget. It is noteworthy that former Governor Gray Davis, who Schwarzenegger replaced in the 2003 recall, supported the governor in this matter. "Neutering a governor during a fiscal crisis is irresponsible," Davis declared in a practical—but not necessarily legally grounded—opinion.[28] But whether a governor had the ability to impose line-item vetoes to a budget modification was not clear going into the episode.

Because of the budgetary and political turmoil in California, the idea of some kind of federal assistance to the state was raised periodically by state leaders. But the notion of a federal guarantee of California borrowing was reportedly dashed after a meeting with U.S. Treasury Secretary Timothy Geithner. Top Obama administration officials seemingly were hoping that the California problem would be resolved without federal help. They seemed to possess the talent of skilled waiters who know how to appear not to see a concerned diner who is signaling for attention.

Nonetheless, the feds were already indirectly involved in California finances; the state was constrained in what it could cut because of its receipt of federal stimulus funding. That funding came with restrictions on trying to support existing programs with federal monies. Stimulus funding was intended to *add* to economic activity, not to pay for programs *already* in place. Thus, the resulting federal "maintenance of effort" rules added another layer to the state budget dilemma.

California was trying to save money by furloughing state workers, a process that resulted in a variety of legal challenges from various public-sector unions. *De facto* pay cuts via furloughs could save some money and—after a brief flurry of lower-level federal attention—seemed not to be subject to federal maintenance of effort or similar rules.[29] However, a mix of conflicting court decisions and appeals made whatever savings emerged from furloughs yet another element of budgetary uncertainty. (The California Supreme Court ultimately let the furloughs stand but made it difficult for future governors to impose them without legislative concurrence.)

Opponents in the legislature charged that worker furloughs at the Franchise Tax Board were hindering tax collections and would cut the budgetary saving forecast by the governor by a third.[30] And concerns were raised about the longer-term effects. It appeared state workers on forced furloughs were taking less straight vacation time, thus accumulating a larger-than-normal "bank" of vacation hours.[31]

Also raising the level of uncertainty was an ongoing conflict between California and the federal courts regarding state prison overcrowding and resultant inadequate health services to prisoners. Litigation was pushing the state toward mechanisms to reduce its prison population. In the short run, that would mean either prisoner releases—with more strain on the parole system—or finding somewhere else to put prisoners.

One option—as noted—was keeping more prisoners in county jails. But that approach would add to the budget strain at the local level. Still another option was an early release of prisoners. More than a fourth of the prison population was potentially involved. Given the political ramifications of such a massive release, the issue was appealed to the U.S. Supreme Court which agreed to consider it in its fall 2010 term.

## REMEDIES: LONG TERM

*"…(T)he people wanted to send Sacramento a message… Do your job. Don't come to us with these complex issues. Live within your means. Get rid of the waste and inefficiencies. And don't raise taxes."*

—Governor Arnold Schwarzenegger, Budget message after May 2009 election [32]

*"There was one and only one on overarching message from the overwhelming majority of voters who DIDN'T EVEN BOTHER TO SHOW UP: Work it out yourselves and stop bothering us."*

—Commentators Jerry Roberts and Phil Trounstine[33]

Despite the governor's stance, various tax proposals were made, e.g., a cigarette tax. However, obtaining a two-thirds vote in the legislature—particularly after the May 2009 election—was never a practical alternative. Of course, tax increases could be approved through the initiative process and various initiative proposals to raise taxes were filed. Ultimately, one proposition that would suspend certain business tax breaks scheduled to go into effect in 2011 (part of the February 2009 budget deal) made it on to the November 2010 ballot (Prop 24).

However, as a practical matter, putting an initiative on the ballot requires extensive signature gathering. The cost of employing professional signature gathering

firms runs $1–$2 million and that sum just puts the matter before the voters; it doesn't enact anything. Still more money, lots more money, is required to mount an election campaign to pass an initiative about which there is any controversy. Public-sector unions could in principle come up with the required funds, but they would be reluctant to throw away money on initiatives likely to be rejected by voters. The only new tax initiative that made it on to the November 2010 ballot was an $18 car fee to aid state parks (Prop 21).[34]

The ongoing budget crisis—particularly after the May 2009 election—seemed to create momentum for discussion of long-term reforms, even if there was stalemate over what to do about a state projected to run short of cash over the summer. Most ambitious was the idea of a state constitutional convention. There had not been such a convention since 1879. A convention could change just about anything in the constitution. And since an unspecified "anything" contains something that might appeal to anyone, the idea had significant support. It appealed particularly to a group of Bay Area/Silicon Valley types who seemed willing to sponsor the necessary initiatives to create the so-called "con-con."

Their efforts in framing these initiatives were aimed to try to constrain what "anything" might entail and particularly to avoid wedge issues such as abortion. The fear was that one hot-button issue in a proposed new constitution could sink the entire package. Ultimately, after initiatives to create the con-con went into circulation, there were second thoughts by backers about where the process might lead. Initially, there were charges that signature-gathering firms were deliberately sabotaging the effort through "dirty tricks."[35] But lack of financial support ultimately led to the abandonment of the effort. Even so, as long as there was budget gridlock in Sacramento, the con-con approach had a certain attraction, although the nickname "con-con" was not exactly good public relations.

Less grand than a full constitutional convention were particular reforms that could be accomplished by ballot proposition. One idea was to pass a constitutional amendment that would prevent future ballot initiatives from going into effect unless they included revenues to cover their costs. Another was to lower one or both of the two-thirds vote requirements (on budget and tax increases).

A more comprehensive initiative to change both requirements to a simple majority pushed by a UC-Berkeley professor had no money for signature gathering behind it and ultimately failed. It did serve to put to rest the idea that volunteer effort at signature gathering, i.e., one without the resources to pay a signature-gathering firm, would be sufficient to put a controversial fiscal item on the ballot. On the other hand, an initiative effort focused only on the budget two-thirds rule had wider backing and was put before voters in the November 2010 general election.

Still another reform the post-May 2009 budget problem resurrected was a longstanding proposal to modify Prop 13 and adopt a "split roll" assessment for commercial property. Under this approach (which has several variants), commercial property would effectively be taxed higher and under a different system than residential. The assessor of San Francisco launched a campaign for that option shortly after the May 2009 election.

Since the property tax is local, adding property tax revenue through a split roll would not directly affect the state's general fund. But it would provide a source of revenue to local governments that were being raided by the state in various ways to deal with its problems. So indirectly, it would offset what the state was doing to the locals. However, as of this writing, a serious campaign for some form of split-roll has yet to be mounted.

# WHAT DO WE DO NOW?

*"The Big Five is not a perfect process. But it's a lot better than hanging 120 legislators out to dry while they get beat up by interest groups."*

—Dan Schnur, director, USC Unruh Institute of Politics[36]

*"What we need to do is just basically cut off all the funding and just let them have a taste of what it is like when the state comes to a shutdown—grinding halt."*

—Governor Arnold Schwarzenegger[37]

The immediate problem of the budget after the May 2009 special election could not be addressed with long-term reforms, particularly those that had to be vetted by voters. To some extent, discussion of long-term reforms was a diversion from what needed to be done quickly before the state exhausted its cash reserves, as it was projected to do over the summer. Indeed, after the May 2009 special election and voter rejection, "long term" soon became anything that couldn't be done in the next few weeks.

Normally, in the period after a May revise, the traditional approach was to gather a meeting of the "Big Five"—the governor and the four legislative leaders from both houses—to cut a deal, rather than rely on the full legislature. Such a process had been used since the 1980s, but in the tense atmosphere after May 2009, complaints were made that it wasn't "transparent." By 2009, transparency had been elevated by the earlier financial crisis into a Biblical virtue. (The mortgage-related securities that were seen as a major component of the 2008 financial crisis were said to be non-transparent.)

Of course, the strength of the Big Five process was precisely that it took place in the proverbial smoke-filled room of opaque deal-making (although in the contemporary version, even the cigar-smoking Schwarzenegger couldn't light up inside the Capitol building). Budget negotiations, especially in the political arena, are bound to involve trade-offs and compromises that will upset various interest groups. True transparency of the process can lead to its failure.

However, there has to be enough overlapping interest to come to an agreement, even in a non-transparent process. Democrats were pushing for tax increases—despite the May 2009 vote. The governor and legislative Republicans were pushing a cuts-only approach. And there was some hope on both sides—despite what the Feds were saying—for a Washington bailout.

But the bailout did not come and there was no overlap among the two sides. Attempts at humor failed in the resulting tension. Senate president Darrell Steinberg sent the governor a basket of mushrooms after the governor called Senate budget proposals "hallucinatory." The governor sent Steinberg a sculpture of bull testicles with a note that he would need them to make budget decisions—which Steinberg returned and for which he received an apology.[38]

Meanwhile, economic pressures and budgetary constraints were having ripple effects. The City of Oakland publicly considered bankruptcy in June 2009 (although it did not go there). Educational and student loans to state teachers and nurses were not being repaid on schedule, threatening the solvency of the special fund that provides them. The governor backed off a proposal to cut payments to families of police and firefighters killed in the line of duty. He also (temporarily, as it turned out) backed off a proposal to sell state assets to raise cash, citing the poor commercial real estate market.

But the ripple effects persisted. Los Angeles County's short-term notes suffered a ratings downgrade. The University of California announced it would be

reducing enrollment for the coming year due to the budget squeeze. University of California (UC) faculty sent a letter to the Regents criticizing them for inaction in the face of a budget crisis. In response to such developments, the legislature cut its own budget and imposed furloughs on its staff.

The atmosphere of crisis pitted Democratic state administrative elected officials against Democrats in the legislature. Treasurer Bill Lockyer urged that an adequate state reserve be maintained to making borrowing—the task of the state treasurer—easier. Along with controller John Chiang, he warned that the state would run out of cash by late July and have to issue IOUs—known as registered warrants—to suppliers and others unless the legislature enacted a modified budget.

To conserve cash, the state cancelled various existing contracts with outside businesses and delayed payments to others. State superintendent Jack O'Connell criticized a legislative plan—pushed by Democrats and opposed by Republicans—to suspend the high school exit exam, ostensibly to provide relief for budget-constrained school districts. One fiscally-conservative state assemblyman, who was at odds with his Democratic colleagues over the budget, left the party and became an independent.

In late June 2009, the assembly passed three bills aimed at conserving cash by delaying payments to schools and local governments. Dealing with the budget in pieces and using borrowing to bring the budget back into some version of "balance" over a multiyear period seemed to be the Democrats' favored approach. But their approach was not clearly articulated—at least in public. Nonetheless, one of former Governor Davis' finance directors advocated that strategy explicitly. [39] However, Governor Schwarzenegger vowed to veto any temporary measures.

In any event, Republicans in the Senate ultimately blocked the Democrats' approach. And a more general legislative stalemate hindered any other deal-making. Courts continued to intervene regarding mandates for prison spending and by halting a wage cut for home care aides. Pet ideas kept being floated, some of which would have only long-term effects (e.g., pension reform) and some of which were questionable even as short-term measures (e.g., selling the state workers' compensation system to private buyers).

The governor threatened an increase in furlough days for state workers hoping it would give him leverage with Democrats anxious to avoid negative outcomes for public sector unions and employees. What he could not do, as he tried and failed to do in the budget stalemate a year earlier, was to cut state workers to the minimum wage. The minimum wage rule applied only to situations in which the state entered the new fiscal year with no budget in place. This time there *was* a budget in place for 2009–10—the one enacted in February 2009—albeit one that was unsustainable.

As the end of fiscal 2008–09 approached, Democrats came up with an elaborate approach that would raise taxes but avoid the two-thirds rule. It involved cutting the gasoline tax and raising taxes on cigarettes and oil production by an equivalent amount. The rationale for a simple majority was that there was no net tax increase. However, the lost gasoline tax revenue would be replaced by a gasoline fee, since raising user fees does not require a two-thirds vote. This elaborate, and potentially legally-challengeable approach, was met by an assurance from the governor that he would veto the package. So, in the end, passing the package was a device for legislative Democrats to shift the blame for the budget crisis and impending IOUs to the governor.

## NO DEAL

*"It's abundantly clear that just because you change governors, you don't change the financial condition of the state."*
—former Governor Gray Davis [40]

*"The problem is, no one wants to say what (any) program increase is really going to cost, or how much money (any) tax cut will cost today, tomorrow and years down the line."*
—former Assembly speaker Willie Brown [41]

Although unlike prior years in which stalemate resulted in no budget on July 1, this time the significance of July 1 was that the controller indicated he would start issuing IOUs (registered warrants) to save cash if no new budget deal had been enacted by that date. IOUs had not been issued by the state since 1992, during then-Governor Pete Wilson's budget crisis.[42] When there was no budget on July 1 this time, some banks indicated they would accept the 2009 edition of IOUs from existing customers at face value, at least for a limited time. Other banks did not. Most of those banks that did had discontinued the practice by mid-July.

Those individuals and businesses that held, or had to hold, the IOUs could not redeem them from the state until October. Although the IOUs paid interest at 3.75% per annum (tax-free)—a high rate for a short-term investment at the time—not all recipients, particularly those whose banks would not accept them at face value, were mollified. Controller John Chiang's Web site deflected objections with the suggestion that those recipients with complaints could "contact the governor or (their) local representative in the Senate and Assembly."[43] The impact of the issuance of IOUs was softened by an announcement about a week after the program began that they could be used to pay state income and corporate taxes.[44]

At the same time that IOUs were being announced, Governor Schwarzenegger boosted state worker furlough days from two to three. Complaints regarding that decision wound up in court, ultimately producing a mix of verdicts until they reached the state Supreme Court, some endorsing and some rejecting the policy depending on the employee group and court involved. In some cases, the furloughs affected workers not supported by the general fund.[45] That gubernatorial decision seemed to be partly symbolic and partly a way to push public worker unions to pressure legislative Democrats. (As noted earlier, the state Supreme Court eventually upheld the governor's furloughs.)

The governor also attacked "fraud and waste" in state government.[46] In a TV commercial, he asked viewers to "stand for California" and support him in the budget battle. [47] Much of the public rhetoric focused on Prop 98's guarantee of funding for schools and the appropriation for, and administration of, a program to provide home care aides (In-Home Supportive Services or IHSS).[48] These areas of contention were forerunners of the budget negotiations that would take place a year later as the fiscal crisis lingered.

With no resolution in sight, California experienced a downgrade of its bond ratings. Parallels were drawn with the federal assistance provided to New York City during its financial crisis in the mid-1970s in exchange for external fiscal controls.[49] However, the Obama administration continued to be intent on averting its eyes from the California spectacle. The closest scrutiny from Washington came in the form of a ruling by the SEC that the registered warrants were securities subject to federal law in order to head off some fly-by-night trading schemes that began to arise.

The fiscal crisis opened the door to tactics and responses outside the legislature. Marijuana growers and distributors saw a chance to legitimize their trade by offering to have their product taxed as part of a legalization. Eventually, the offer evolved into an initiative placed on the November 2010 ballot (Prop 19). The American Cancer Society pushed for an added

tax on tobacco. Wacky initiatives were submitted; it only costs $200 to file a proposition. One, for example, would have required drug testing of members of the legislature.

The California State University system (CSU) announced it would consider a significant tuition increase and announced there would be closed enrollment in the following spring semester. UC developed its own furlough plan, since it was not subject to the governor's authority. Public transit operators began to consider a ballot initiative that would protect their earmarked state funding from being raided to deal with the General Fund's problems. An initiative to that effect also ended up on the November 2010 ballot (Prop 22). Meanwhile, the state asked its private vendors if they would voluntarily cut their prices—even though these prices were already contracted.

Adding to the budgetary distress were court decisions arising from challenges to prior spending cuts. For example, the state's earlier Medi-Cal cuts were ruled violations of federal laws because the low reimbursements to providers did not offer quality health care to patients. As noted earlier, another court ruling rescinded a wage cut to state-supported home care aides.

However, the courts were also seen as a possible forum to deal with the legislative stalemate. Former UCLA chancellor Charles Young filed a suit challenging the feature of Proposition 13 of 1978 which added a two-thirds vote requirement for tax increases. The suit argued that the added supermajority requirement was a "revision" of the constitution, not just an amendment, and thus could not be enacted by initiative. (The original suit was rejected but was later re-filed. At this writing, it is still pending.)

Various proposals of the governor ran into strong opposition. These included suspension of Prop 98, the minimum guarantee for K-14 funding, and the proposed partial sale of the state's Workers' Comp fund (formally known as the State Compensation Insurance Fund). A suspension of Prop 98 was strongly opposed by the California Teachers Association and other education-related groups. And the governing board of the Workers' Comp fund—which covers mainly smaller employers and about a fifth of the market—opposed its sale.

Both the Service Employees International Union (SEIU) and the California Correctional Police Officers Association (prison guards) threatened—but did not carry out—strike actions over contract disputes with the state. Although voters in May had rejected diverting funding from early childhood programs to the General Fund, the First 5 California Families Commission—which administers the earmarked monies—offered some assistance to the state. Its objective was to head off loss of child access to the state's Healthy Families program. (Healthy Families is part of a federal-state program providing health insurance to children of the working poor.) Meanwhile, the governor ordered a "garage sale" of state vehicles (some of which he personally autographed to increase their value) and other miscellaneous state property.

Budget strains were evident inside affected organizations. A community college president in San Francisco floated the idea of offering "naming rights" to sponsors of particular courses. After a controversy developed, the idea was dropped. Some department chairs at UC-San Diego suggested that budget cuts should be concentrated at less-prestigious campuses such as Merced and Riverside. At CSU, the faculty union approved a furlough plan but voted "no confidence" in the CSU system's chancellor.

## DEAL

*"I always distinguish between the best possible solution and the best solution possible. This is the best solution possible."*
—Rick Simpson, Policy advisor to Assembly Democrats[50]

*"The governor and the legislative leaders are implicitly telling us that flawed as it may be, the budget is the best they can do. The most damning aspect of this tiresome situation is that the best budget our political system can produce is deceptive and fundamentally dishonest. It should tell us that we have a much bigger problem than an unbalanced budget."*
—Columnist Dan Walters [51]

By late July, the outlines of a revised budget deal began to emerge as the result of on-and-off negotiations at the "Big 5" level followed by an all-night session at the legislature. Along the way, frictions arose over such issues as possible early prison releases and there were threats of lawsuits over possible raids on local government revenues. The solution to the former was to cut the prison budget without using the words "early release." At some later date, someone—but not the legislature—would specify later how the prison cuts would be made. In the latter case, eventually deals were concluded with local government representatives.

Various cuts in K-14 and higher education were made along with reductions in social programs and a furlough day was added for state workers (to three per month). [52] The latter recognized in a budgetary sense the furloughs already ordered by the governor—and ultimately provided a rationale for the state Supreme Court to okay the furloughs. Borrowing from local government funds was part of the deal. Various assumptions were made about things that in fact did not happen, such as partial privatizing of the state's workers' comp fund and offshore drilling licensing (the latter killed by the BP deep drilling fiasco in the Gulf of Mexico a year later).[53]

Some components addressed cash flow within the fiscal year by accelerating tax withholding. Normally, extra money received within a year in withholding is essentially borrowed against the following year. However, in this case, the new schedule would repeat indefinitely, thus providing a one-year windfall that would not be repaid in the future.

In the same spirit, the final state payroll at the end of June 2010 was moved to the beginning of July, thus taking one-twelfth of the payroll out of the 2009–10 budget. This one-time "saving" could only be maintained if—from that point on—the June 30 payroll was paid on July 1 of all successive years. Some budget cuts were partly "backfilled" through use of federal stimulus funding (which would not be available in future years). In short, the budget deal was partly composed by cobbling together a variety of one-time arrangements.

The governor and legislative leaders touted what they termed solutions to a "$60 billion budget gap" for 2009-10 over the period February through July 2009 when the revisions were signed on July 28. That approach to framing the problem can be viewed as part of the longer-term budget dilemma. In round numbers, the budget at its peak was about $100 billion per annum. Thus, the announcement that a "gap" of $60 billion had been filled might lead one to think that there was somehow a budget of only $40 billion left. Any such cut, of course, would have been impossible to achieve. The $60 billion number in reality was a mix of years, of actual and projected flows of spending and receipts, and of stocks and flows.

Even apart from the confusing accounting methodology, elements of the July budget deal left significant loose ends. As noted earlier, although the governor vetoed well over $400 million in expenditures, it was unclear at the time that he could veto line items in a budget revision as opposed to a complete budget.[54] (The state Supreme Court eventually approved the vetoes; a significant factor in its verdict was that the legislature had gone along

implicitly by adjusting the budget to reflect the payroll savings.) A cut in the prison budget, despite federal court supervision and despite no specification of a prisoner release program, was another area of uncertainty. Local redevelopment agencies—whose funds were to be borrowed—litigated the constitutionality of such borrowing (and eventually lost).

Finally, there was the underlying economy whose outlook in the summer of 2009 was more uncertain than usual. The official estimate when the budget revision was passed of revenue that would be received in 2009-10 was approximately $95 billion. In fact, actual receipts came in at well under $90 billion, despite the February 2009 increases in income, sales, and car tax rates.[55]

## AFTERMATH

*"Because the legislature failed to send him a balanced budget… the Governor was forced to make these difficult cuts. While Democrats are focused on a protracted battle to dig the state back into deficit, the Governor will continue to focus on moving our state forward…"*

—Gubernatorial spokesperson Aaron McLear, responding to lawsuit against the governor's line-item vetoes [56]

*"We elected a governor, not an emperor."*

—Senate President Darrell Steinberg[57]

Indeed, it did not take long for complications to occur. As noted earlier, although the budget deal cut the prison budget, it did not explicitly specify releasing prisoners as a cost-saving device. In early August 2009, however, a federal court ordered California to reduce its prison population by over 40,000 (out of about 150,000). The governor's target for reduction was 27,000. State attorney general Jerry Brown, still at that time an unannounced candidate for governor in 2010, promised to appeal; at this writing the case is before the U.S. Supreme Court. Highlighting the issue was a riot at a state prison in Chino in early August, leading to a debate over whether overcrowding was a cause and whether the riot proved that prisoner releases should be avoided.

The controversy, discussed earlier, over the validity of the line-item vetoes remained a political sore spot, apart from the legalities. It was claimed by legislative Democrats that they had a deal with the governor as part of the Big 5 negotiations that there would be no such vetoes. But the governor claimed that the understanding of no vetoes was undermined by subsequent legislative actions that cut into projected revenue. The budget thus remained an area of friction between legislative leaders and the governor. Public pensions and retiree healthcare benefits, notably CalPERS, CalSTRS, and UCRS, also became issues of controversy after the budget deal. Such plans became notably underfunded in the wake of the 2008 financial crisis, thus requiring increased contributions. At one point during the 2005 "Year of Reform," the governor had been pushing for an initiative on the pension issue but because of poor drafting, he pulled his support and the issue was not placed on the ballot.

During the 2010 gubernatorial campaign, GOP candidate Meg Whitman, even before the primary, apparently decided that having a pension initiative on the November ballot would attract union members and Democrats to vote in opposition. From her campaign's perspective, that outcome would not have been advisable. Proponents of such an initiative complained that "certain people" who "didn't want this on the ballot with them" refused to support their initiative.[58] However, the issue continued to rise and fall in media attention after the July budget deal. And in the atmosphere of cutbacks and furloughs, the availability of such pensions seemed to produce an increase in early retirements in the public sector.

There was disagreement about side deals that had been made as part of the budget agreement in July, leading to a feud between Senate President Darrell Steinberg and the Senate minority leader Dennis

Hollingsworth. The governor was reportedly somewhere in the middle trying to mediate between the two in a Big 5 session in the fall of 2009. Assembly majority leader Alberto Torrico accused the governor of "extortion" and Hollingsworth of sending the equivalent of "ransom notes." [59]

The governor was booed when he made what he thought would be a courtesy visit to a Democratic meeting at a San Francisco hotel at the invitation of former assembly speaker Willie Brown. This episode, complete with YouTube videos of the occurrence, was clearly an embarrassment to Brown, who termed the behavior "totally inappropriate." [60] One legislator who made rude remarks at the event was rewarded later with a veto message of a bill he authored with the first letter of each line in the message spelling out an obscenity.[61]

There was also friction between the governor (this time in accord with legislative Republicans) and Democratic leaders over the placement of a major water bond issue before voters. The conflict was mainly over provisions of such a bond measure. Schwarzenegger threatened to veto all bills until some agreement was reached. As it turned out, after placing the bond on the November 2010 ballot, the governor and legislature agreed in the summer of 2010 to postpone it to 2012; given the poor economy at the time and general public disenchantment with Sacramento, the bond's chances for passage looked grim.[62]

When the issue of whether such a threat by the governor was legal came to Attorney General Jerry Brown, he declined to opine with the reminder that "compromise in the rough-and-tumble legislative process is not achieved by doilies and tea." [63] Meanwhile, Local 1000 of SEIU and the Schwarzenegger administration feuded over whether Columbus Day was a paid holiday for state workers, since the legislature had never ratified the union's contract deleting it. [64] (A later court decision involving another state government union upheld the elimination of the Columbus Day holiday in February 2010.) Representatives of K-12 schools threatened a lawsuit claiming that state funding of public education did not meet California's constitutional requirements.[65]

However, for members of the public who were not government employees, who were not enrolled in a public higher education institution, and who were not dependent on social programs, consciousness of the budget problem was episodic. Those Californians who frequented state parks might have experienced reduced hours.[66] But even some of the potentially high-profile cuts in social programs, such as pushing children off the Healthy Families program, never quite happened.[67] Cuts in other programs—that attracted less public attention—such as screenings of low-income women for breast cancer, did occur. Courts were subject to periodic closures as was the Department of Motor Vehicles (DMV). The latter may have been an attempt to engage public attention. A significant portion of DMV costs are paid through various motor vehicle fees, not out of the general fund budget.

At the local level, fees and traffic fines rose as local governments sought revenue. But by mid-August, the state controller announced that IOUs would no longer be necessary after early September, in part due to a loan from JPMorgan Chase. Still, despite the loan and the end of the IOUs, the Treasurer had difficulty selling state bonds in October 2009 and had to reduce the size of a planned offering.

In spite of a general sense of state government dysfunction, there was not much impact on the life a typical voter. That feature of the budget crisis undoubtedly was a factor in the failure of advocates of grand reforms to carry public opinion. Thus, for example, the excitement about having a new state constitutional convention (con-con) was largely confined to a limited circle of policy wonks and good government advocates. As noted earlier, proponents of the con-con never raised enough money to put

the enabling initiatives on the ballot. Poll data had suggested that voters by a slim majority favored the idea of such a convention but also that they had no particular consensus on what specific reforms the convention might address. [68]

There was likely a gap between voter perceptions and policy wonk perceptions more generally. In policy circles, there is a view that California's direct democracy system of ballot initiatives has become a major factor in state dysfunction. But voters like the system, even though they complain about complex ballots and being asked to do the legislature's work. Perhaps symbolic of this gap were the comments of California historian Kevin Starr when he spoke in honor of Governor Hiram Johnson whose progressive agenda created the state's direct democracy in the early 20th century. "He got California ready for the 20th century," said Starr. [69] Pointedly, he did not extend his remarks about readiness into the 21st century.

The governor flirted with endorsing a reversion to a part-time legislature in late August "as one of the many ideas he's taking a look at," according to a spokesperson.[70] A year later, 2010 Republican gubernatorial candidate Meg Whitman seemed to pick up that message; she also made statements about a part-time legislature as well as California's proneness to too many ballot measures.[71] Governor Schwarzenegger pushed for K-12 reforms to increase California's chances in competition with other states for "Race to the Top" funds from the U.S. Department of Education. Ultimately, with union resistance as an important factor, California did not obtain those funds. (A second application involving a subset of school systems was filed but was unsuccessful.) At the higher education level, the budget crunch led to tuition increases and efforts to recruit more out-of-state students who would pay higher tuition than Californians.[72]

To the extent there was structural reform on the ballot as the result of California's fiscal distress, it came in the form of Prop 14 in June 2010, a byproduct of the February 2009 budget deal.[73] Prop 14 created an open (nonpartisan) primary system for legislative positions on the argument that more "centrist" candidates would emerge. It ultimately was passed by the voters despite opposition from the political parties. Whether a court challenge will eventually be filed by either of the two major parties is not known at this writing; gubernatorial candidate Brown expressed some positive views on Prop 14 which might inhibit Democratic participation in such a suit. But minor parties—who might well be excluded from the general election under Prop 14—did sue.[74]

## FALL 2009: THE PAUSE THAT DISTRESSES

*"As a candidate, if you even peep about a tax, you're dead."*

—attorney general (and unofficial gubernatorial candidate) Jerry Brown in late October 2009 [75]

*"I'm absolutely convinced that lowering tax rates will produce an increase in tax revenues."*

—insurance commissioner (and gubernatorial candidate) Steve Poizner [76]

The fall of 2009 was a period of pause while Californians awaited a renewed budget problem to be revealed in the governor's January presentation. But doing nothing in that interval did not improve the fiscal situation. Given the fact that taxes had been raised in the February 2009 deal, that voters had rejected an extension of those taxes, that Republican legislators who went along with the February deal had been punished politically, and that the two-thirds vote requirement for tax increases remained in effect, it seemed unlikely that new state taxes would be on offer for the 2010-11 budget. At the local level, due to a negative inflation factor, property taxes were due to *fall* very slightly after a state Board of Equalization calculation.

Moreover, there was unfinished business from the 2009-10 budget. Over twenty legal cases against the governor's imposition of furloughs on state workers were awaiting court action. Exactly how these would play out was unclear at the time. But to the extent furloughs might have been voided (which ultimately did not happen), the state budget could have suffer from awards of back pay.

Tuition at state public universities was seen as likely to rise in the wake of the 2009-10 budget. But, a report by the Legislative Analyst on the 50th anniversary of the state's Master Plan for Higher Education noted that state policy no longer provided guidance as to the split between student and state in providing educational finance.[77] Analysis of political forces in California suggested that institutional pressures could be expected to reduce the share of higher education in the overall budget, a process that could lead to *de facto* privatization.[78] Yet a Public Policy Institute of California (PPIC) poll indicated that over two-thirds of Californians opposed raising student tuition to support public higher education. Over half opposed raising taxes for that purpose. [79] Despite this sentiment, an earlier PPIC report indicated that California's workforce would need more college graduates in the future. [80]

More generally, at about the same time eight out of ten Californians in a *Los Angeles Times*/USC poll thought that the state was headed in the wrong direction. And over half saw the decline as long-term.[81] In such a pessimistic atmosphere, it was not surprising that public views about state issues such as higher education finance were often incoherent. Surprise or not, such incoherence added to the difficulty of crafting budgets.

Perhaps sensing that there could only be more fiscal distress ahead, the governor's finance director Mike Genest let it be known that he would resign by the end of 2009. *"It feels like a good time for me to step back from the day-to-day fray of things,"* he said in an understatement. [82] In an interview, he indicated he had researched options for a state bankruptcy and found no legal procedures for a state to do so. *"I literally looked… to see if there was a way for states to return to territory status,"* Genest said. [83] Presumably, he found no options for such a return to the past. However, after resigning, he reportedly planned to go scuba diving in a former U.S. territory, the Philippines, just as the governor and the new finance director were unveiling the new budget. [84]

In the political sphere, San Francisco mayor Gavin Newsom officially bowed out of the governor's race on the Democratic side in late October 2009, despite an endorsement by former President Bill Clinton. He instead began to campaign for the Democratic nomination for lieutenant governor, an office whose lack of power he had earlier derided. That move left only Jerry Brown in the Democratic race, albeit unofficially at that point, with periodic rumors—that never proved true—that other candidates from his party might yet declare themselves. [85]

Also among things that didn't happen was a "split roll" initiative filed by the California Teachers Association (CTA). As noted earlier, under a split roll, Prop 13 would be modified to allow higher taxation of commercial property compared with residential. CTA did file two such initiatives in November 2009, but never gathered the signatures to put the issue on the ballot. Similarly, a group pushing for reduced public pension debt filed two initiatives in November, but never obtained the needed signatures. [86]

Among things that did happen was a *de facto* interest-free loan to the state created by increased income tax withholding. The legislature could accelerate tax withholding—as opposed to raising tax rates—by a simple majority. Although workers could in theory ask employers to reduce their withholding levels, human inertia meant that most did not do so. The impact of the new withholding rates became particularly important

during the summer of 2010. Added cash flows to the state helped staved off the issuance of IOUs that had occurred in the previous summer. However, the enhanced cash flows were somewhat offset by increases in unpaid tax liabilities, a reflection of the soft economy.

Generally, the state was hungry for cash. Its borrowing from funds outside the general fund suggested a literal nickel-and-dime approach. In particular, the state fund for recycling bottles and cans—based on deposits paid by purchasers of beverages—became sufficiently depleted by its loan to the general fund that recyclers sued the state in November 2009. Absent cash in the fund, recycling firms were not being paid for their services. After negative publicity, the governor promised in January to pay off the loan that was hobbling the fund. But complaints about unpaid bills owed to recyclers continued. [87]

The cash squeeze produced a short-term mentality. With the 2010 *Census of Population* looming, states could anticipate federal funding benefits by having the fullest possible count of residents. However, California allocated only a token amount for its effort to urge residents to cooperate with the census. The full-count issue was especially pressing for California because of its large immigrant (including illegal immigrant) population—which might prefer to avoid official contacts. But the benefits from a full count would be felt over the coming decade, not immediately, and so were not a high priority.

California's short-term mentality was also reflected in the development of a plan to sell state office buildings and lease them back. In effect, such arrangements are equivalent to borrowing. Cash is received up front—as in a bond sale. But then a stream of revenue over time is paid out—also as in a bond—in the form of future rents to the new owner. Eventually, a balloon payment at the end occurs when the state must either renew the lease or build or buy a new building.

While analogous to borrowing, such assets sales tend to be a very expensive method of obtaining immediate cash, although they avoid constitutional constraints on borrowing. The governor promised to "guarantee" not to sell if the prices were not right but it seemed unlikely that he could avoid de facto borrowing at what were implicitly high rates of interest. [88] In December 2009, a real estate broker was selected to prepare the sales. [89]

A plan to sell the state's EdFund—which provides loans to students—ultimately ran into a roadblock. The federal government, which is involved in the program, ordered a halt to the process in late July 2010. Concerned about poor administration, the U.S. Department of Education later assigned an out-of-state management firm to operate the EdFund. [90]

Both CSU and UC raised fees substantially in November 2009, despite vocal (and in some cases physical) student protests. Partly in response, a joint committee of the legislature was set up to review the 1960 Master Plan for Higher Education. The *Huffington Post* ran a mock article in late December indicating that UC-Berkeley had decided to eliminate students altogether and wait for the economy to recover. [91] In contrast to the rise in tuition, in December salaries of legislators and various elected state officials went down. The pay cut came after attorney general (and still-unofficial gubernatorial candidate) Jerry Brown ruled that such reductions—as determined by an independent tribunal—were legal.

In other legal affairs, a federal court confirmed its earlier order of a reduction (not exactly the same as a "release") of California's prison population by about 40,000 over two years due to overcrowding.[92] The order came at about the same time Congress was cutting back on the aid California receives from the federal for holding illegal aliens convicted of crimes. With the focus on prisons, not surprisingly various exposés appeared in the media about excessive overtime, costly use of temps, and other expensive practices in California's prison administration.

Although Republican legislative leaders who had approved the February 2009 budget deal had been punished, one Republican—Abel Maldonado—was rewarded. Maldonado's needed vote to pass that deal produced both changes in the deal itself and the placing of a proposition—which passed—on the June 2010 ballot to create a non-partisan primary system. As noted earlier, Governor Schwarzenegger, a proponent of what was termed "post-partisan" politics, nominated Maldonado in late November 2009 to the vacant lieutenant governorship position, making the announcement on the *The Tonight Show with Jay Leno*.[93] The nomination led to complex on-and-off political manipulations but Maldonado was eventually confirmed by the legislature in late April 2010. As the incumbent in the June 2010 primary, he won the Republican nomination for Lieutenant Governor to oppose Democrat Gavin Newsom in November.

As calendar 2009 came to an end, Governor Schwarzenegger wrote to U.S. House of Representatives speaker Nancy Pelosi asking for more aid to California for health care programs and avoidance of costly mandates.[94] At the time, Congress was still considering the President's plan for universal health care. The letter was mild in tone, but it set the stage for a much more stinging complaint by the governor early in 2010 regarding the matter. Meanwhile, as is the custom as the time for a new budget message (for 2010-11) approached, leaks of information appeared in the media. To no one's shock, the main message was that there would be more cuts proposed for the coming fiscal year.

# THE NEXT ROUND: THE 2010–2011 FISCAL YEAR BATTLE BEGINS

*"Federal funds have to be part of our budget solution because the federal government is part of our budget problem… And now Congress is about to pile billions more onto California with the new health care bill… Health care reform… has become a trough of bribes, deals and loopholes… You've heard of the bridge to nowhere. Well this is health care to nowhere."*

—Governor Arnold Schwarzenegger, January 2010 State of the State speech[95]

*"I love the way that Arnold is so optimistic. But now, he's got to knock heads together."*

—Attorney General (and unofficial Democratic gubernatorial candidate) Jerry Brown commenting on governor's State of the State speech[96]

*"Governor Schwarzenegger's remarks were a sober reminder that we have a government we can no longer afford and we have serious challenges to overcome."*

—Meg Whitman, Republican gubernatorial candidate, commenting on governor's 2010 State of the State speech[97]

Under the California constitution, the governor delivers a State of the State message and a proposed budget for the next fiscal year in early January. Since the State of the State comes first, it often provides a preview of the more detailed budget proposal. It has become a practice for the governor also to deliver a May revise budget message, based on new economic projections and political developments, in mid-May. Then the legislature enacts a budget, in principle before the start of the new fiscal year in July, but more often late. The new fiscal year (2010-11) was to set a record for delay in enactment.

**Table 4: January and May Revise Budget Proposal: 2010 ($ Billions)**

| | 2009-10 As of Jan. 2010 Proposal | 2010-11 As Proposed by Governor Jan. 2010 | 2010-11 Workload Budget as of Jan. 2010 |
|---|---|---|---|
| Revenue & Transfers | $88.1 | $89.3 | $90.3 |
| Expenditures | $86.1 | $82.9 | $102.6 |
| Surplus/Deficit | +$2.0 | +$6.4 | -$12.3 |
| Reserve at End of Yea | -$5.4 | +$1.0 | -$18.0 |

| | 2009-10 As of May Revise Proposal | 2010-11 As Proposed by Governor May Revise | 2010-11 Workload Budget as of May Revise |
|---|---|---|---|
| Revenue & Transfers | $86.5 | $91.5 | $89.3 |
| Expenditures | $86.5 | $83.4 | $99.5 |
| Surplus/Deficit | $0.0 | +$8.0 | -$10.2 |
| Reserve at End of Year | -$6.8 | +$1.2 | -$17.9 |

Note: Details may not add to totals due to rounding.

Source: California Department of Finance, January and May Revise budget summaries.

As described earlier, there was a departure from the standard scenario in February 2009, when the legislature enacted both modifications to the ongoing fiscal year (2008-09) and a new 2009-10 budget. But apart from record delay, calendar 2010 initially followed the standard script. Before describing the 2010 process, it is useful to look ahead at the data behind the January 2010 and the 2010 May revise, found on **Table 4**.

The first thing to note is that by January 2010, the projections for the 2009-10 fiscal year—by then half way over—were for rough balance. Indeed, a nominal surplus is shown. Even after the May revise, the balance estimate was retained. Of course, the 2009–10 budget was filled with one-time fixes—such as moving the end-of-June payroll to the beginning of July (the next fiscal year); "smoke and mirrors" is the term of art. Nonetheless, it is noteworthy that with the gimmicks in place, at least the state did not technically accrue additional debt during 2009-10 when the books were closed. The rough balance of Table 4 accords generally with the cash flow data summarized earlier on Charts 1-3. Put another way, at least it can be said that the smoke and mirrors succeeded in creating an illusion of fiscal adjustment—it could have been worse.

If there was an approximate bookkeeping balance in 2009–10, what were the challenges for 2010–11? There were two basic problems. First, on a "workload" basis, the budget would run a significant deficit in the 2010-11 year. Hence, just to have another year of rough balance, either more revenue or less expenditure or some combination of both would be needed. In January 2010, as Table 4 indicates, the governor estimated that about $12 billion in solutions would be needed for such balance. This estimate was revised downward to about $10 billion at the time of the subsequent May revise. Given that magnitude, it was not surprising that the governor hoped to pressure Washington for a significant portion of the solution.

However, the governor also wanted to pay off the negative balance in the general fund by the end of the 2010-11 fiscal year. He could argue that the California constitution, partly after his Props 57 and 58 of 2004, required that the entire problem (balance plus debt repayment) had to occur by June 30, 2011. Indeed, he wanted more: to end the 2010-11 fiscal year with a positive balance of about $1 billion—or at least be on track to do so when his term as governor ended in January 2011.

Despite the governor's desire, the options for extending the deadline for a complete fix beyond that June 2011 date were limited. But they were not completely absent, particularly if more smoke and mirrors could be applied. Creative minds are always available to provide some leeway. In addition, the governor wanted to achieve the fix without new taxes. Given those gubernatorial goals, along with the two-thirds votes needed for budget enactment and for tax increases, and given the still-soggy state of the California economy, a budget collision—with a stalemate after July 1, 2010—was assured.

Adding to the assurance of a major political tangle surrounding the budget was the fact that 2010 was an election year. For Governor Schwarzenegger, who was soon to be termed out, it meant a last chance for a legacy. His 2005 "Year of Reform" had been a bust. But he did obtain one of his 2005 reforms, in a rewritten format, in 2008, i.e., legislative redistricting to be done outside the legislature. As it turned out, however, he would have to defend even that victory in November 2010 against an initiative (Prop 27) to undo the 2008 proposition.

The governor's environmental record was also to be put on the line in November 2010 with an initiative to suspend AB32 (Prop 23), California's greenhouse gas law. And even sooner, there was to be an initiative for a non-partisan primary system on the ballot in June 2010, an idea the "post-partisan" governor supported. These ballot items made for odd alliances. Republicans favored the 2008 redistricting initiative. But party leaders in both the Republican and Democratic establishments generally disliked the non-partisan primary. Democrats opposed suspension of AB32 but Republicans supported it.

As an odd couple, there was former Democratic assembly speaker Willie Brown and Governor Schwarzenegger. Brown had nice things to say about the governor's legacy efforts to roll back certain provisions of public pensions.[98] He even had some nice words about the dead-on-arrival report of the commission on revising the tax system discussed earlier, a report to which Schwarzenegger continued to point as a needed roadmap for reform. On the other hand, Brown indicated that if he were still speaker, he would have passed the governor's May revise proposals, not because he favored them, but because it would have forced the governor to confess to believing in less draconian measures. The governor, he believed, could not have signed his own budget.

Both UC and CSU had pushed up their tuitions—at least the sticker prices—substantially. Student demonstrations in November 2009 protesting the hike at the UC Regents meeting that month had garnered substantial media attention. It was reported in early January that the governor did "not want his legacy to include a dismantling (of) the world's most acclaimed public university system."[99] The governor, it might be noted, is an *ex officio* Regent.

As already partly enumerated, not only were the governorship and other statewide offices up for grabs in November 2010, but there would be controversial items on the ballot. While some potential ballot items might have direct budget implications, there were also considerations of what ballot items might attract particular groups of voters to the polls. For example, when an initiative legalizing marijuana made it on to the November ballot, some observers argued that the issue would attract younger voters to the polls. Some opinion polling for Jerry Brown suggested he was more favorably viewed by younger voters than older. In turn, if he were more likely to win, that prospect might have some effect on legislative Democrats, depending on how they felt the budget battle was affecting the election.

Candidates that were in office could have some impact on the budget, which was inherently an element tied to their campaigns. Insurance commissioner Steve Poizner, a GOP primary candidate in the gubernatorial race, succeeded in tying up Governor Schwarzenegger's plan to sell the state-operated Workers' Compensation fund with a lawsuit. He argued that selling the fund might raise premiums to employers. But that move blocked the planned sale that was supposed to raise $1 billion for the 2009-10 budget.

The 2010 State of the State address started with an elaborate story involving the governor's pet pot-bellied pig and a pony and how they worked as a team to steal his dog's food. Although the metaphor was somewhat obscure, the tale seemed to be a call

**Table 5: California and U.S. Unemployment Rates: Selected Dates**

| | California | U.S. |
|---|---|---|
| **Year 2006** | 4.9% | 4.6% |
| **Year 2007** | 5.3 | 4.6 |
| **Year 2008** | 7.2 | 5.8 |
| **Jan. 2009** State of the State & Budget Messages | 9.7 | 7.7 |
| **Feb. 2009** Midyear Revision of 2008-09 Budget & 2009-10 Budget | 10.2 | 8.2 |
| **May 2009** Voters reject Budget-related Propositions | 11.3 | 9.4 |
| **July 2009** 2009-10 budget Revised & Passed | 11.8 | 9.4 |
| **Jan. 2010** State of the State & Budget Messages | 12.5 | 9.7 |
| **June 2010** 2009-10 Budget Ends With No New Budget Enacted | 12.3 | 9.5 |

Note: Monthly data are seasonally adjusted.

Source: Employment Development Department, http://www.labormarketinfo.edd.ca.gov/?pageid=164

for the two parties in the legislature to work as a team to make painful budget cuts. However, midway through the speech, the governor declared that the "first priority" for 2010 was "jobs, jobs, jobs." As can be seen from **Table 5**, which shows state and U.S. unemployment rates, such a statement was hardly a surprise. Nonetheless, taken by themselves, budget cuts tend to reduce jobs directly if public-sector layoffs occur and have a demand-reducing effect indirectly.

As the table indicates, the California unemployment rate began to rise relative to the U.S. as early as 2007. The state's economy had become heavily dependent on housing, on rising home prices, and on shaky mortgages. So when the bubble began to burst, the impact was disproportionately felt in California. By the time of the January 2009 budget proposal and the budget adoption the following month, state unemployment was already in the 10% range. When voters rejected the budget-related propositions in May 2009 and when the legislature revised the 2009-10 budget, unemployment was over 11%. And by the time of the January 2010 State of the State and budget message, California unemployment was over 12%. And it remained over 12% through the summer of 2010 and Election Day.[100]

But while it was easy, and politically understandable, to proclaim that the priority was jobs, actually doing much about the jobs problem in the short term was another matter. California does not have a monetary policy since there is no California currency and no California central bank. California's scope for mimicking the federal government's fiscal stimulus at the state level was very limited by constraints on the deficits a state could run. And as noted, making painful budget cuts was likely to worsen the local economic picture.

The main latitude that California might have, at least in minimizing the cuts, would have to come—if it were to come—from the federal government. But so far California's efforts to attract federal attention to its budget problems had not been especially successful. Hence, Governor Schwarzenegger complained that the feds should be providing more aid to California. His complaint about the then-pending federal health care bill—reflected in the quote above—could be viewed in that context.

After a meeting with President Obama in February 2010, the governor took a more conciliatory stance saying the Republican demand that a completely new health bill should be enacted was "bogus talk."[101] And once the Obama bill passed, the governor cooperated with its initial subsidy of a state program to cover individual with pre-existing health conditions that had made them otherwise uninsurable. The governor termed the state legislation to implement the federal program a "win-win

opportunity."[102] By October 2010, he was predicting Obama would win re-election in 2012.[103]

Education is often viewed in the jobs context, not as a short-term remedy, but as a way of preparing students for the job market of the future. Hence, there was discussion in the governor's speech about training and education. Included was promise of a proposed constitutional amendment—never in fact put on the ballot—that would preclude California from spending more prisons than on higher education.

The governor reported that almost 11% of the general fund was going to prisons and only 7.5% to higher ed. It appeared he was referring only to UC and CSU since with the community colleges, the state was spending *less* on prisons (10.1%) than on higher education (13%) in 2009-10.[104] Nonetheless, despite the data inaccuracies, the amendment proposal brought the requisite thank-yous from higher education officials, although the actual budget proposal was to eliminate enrollment growth funding for UC and CSU. (No comments on the idea were made by prison authorities.)

In the end, the proposal seemed to be part of an effort by the governor to develop support for the use of private prisons to save money. The Legislative Analyst's Office (LAO) criticized the proposal. In their view, it was yet another potential piece of ballot-box budgeting that would "unwisely" hamper decision-making. [105]

The actual budget message called for $6.9 billion in federal aid to California. If the full amount was not forthcoming, the governor then proposed (threatened?) drastic cuts such as ending the home health care aide program (In-Home Supportive Services or IHSS) and ending welfare-to-work (CalWorks). In part, the proposal seemed to be yet another attempt to attract the attention and assistance of the Obama administration, which had honed its skill at distancing itself from California's fiscal problems during its first year in office. The Legislative Analyst termed the chance of getting the full $6.9 billion "almost non-existent."[106] Initially, the White House resisted a meeting between the President and governor, but a "private" session was eventually arranged for February. Whatever the odds of more federal aid, the state's two Democratic U.S. senators complained about the governor's remarks. The governor's speech seemed to imply they were not doing enough in bringing federal dollars to California in a year in which Senator Barbara Boxer would be up for re-election. According to Senator Dianne Feinstein, "California's budget crisis was created in Sacramento, not Washington."[107] But the governor rejected the push-back. "I think we have made enough noise, even though they are complaining, even though the congressional delegation, you know, now feels guilty. The truth always hurts." [108]

There would be no new taxes under the governor's plan, but over $300 million was supposed to come from installing traffic enforcement cameras and fining offending motorists. A "fee" on property insurance to go to state fire-fighting efforts was proposed. State employees would see an end to furloughs but instead would have a 5% pay cut and an increase in pension contributions by 5%—a net cut of 10%. K-12 would receive about the same nominal funding per student as in 2009-10, a real cut if educational operating costs rose. Some local transportation money was to be diverted to the general fund, triggering an outcry from transit operators. The diversion in part involved the previously-discussed proposed substitution of a gasoline fee for the sales tax on gasoline—since the gas sale tax is normally earmarked for transportation.

# PAUSE II

*"If I had hesitated in my career every time I made a move because it was too hard, I would still be yodeling in Austria."*

—Governor Arnold Schwarzenegger [109]

*"…Schwarzenegger continues to serve—with impossibly good humor—as punching bag and scapegoat for 38 million people who simply refuse to recognized that they can't have something for nothing, and that they themselves are the cause of their systemic troubles."*

—Commentator and Schwarzenegger biographer Joe Mathews [110]

The governor clearly viewed the budget situation in January as requiring prompt attention. He declared a fiscal emergency and called a special legislative session on the budget. However, unlike the previous summer, there was no pressing cash crisis at that moment and no immediate danger of IOUs. Indeed, the state was the beneficiary—at least temporarily—of $50 million in uncashed IOUs from the prior summer that payees had evidently lost or forgotten.

State controller John Chiang warned in late January that a cash crunch might reappear early in the summer of 2010. However, in early February, the Assembly Budget Committee rejected the governor's request to give him authority to defer payments from the state during cash shortages. As it turned out, sufficient revenue came in—particularly during June—thanks to the early withholding schedule that the state had adopted to delay the threat of such a crunch.

Financial markets—which might have been a source of pressure on the state through the bond market—turned out not to be a constraint. The Federal Reserve was holding short-term interest rates on riskless securities close to zero. Investors seemed willing—now that the economy was at least bottoming out—to buy California securities despite the low bond ratings of the state. Thus, concerns that California would be unable to borrow if it didn't enact a budget that seemed "balanced" by some definition turned out to be unwarranted, at least through the summer of 2010. Demand was sufficiently high for California bonds in March that an offering was increased from $2 billion to $2.5 billion.

The result of a lack of pressure on the legislature in the January-June period was little movement on the budget. At one point, legislative Democrats enacted a gas tax/gas sales tax diversion, related to—but not the same as—the diversion proposed in the governor's January budget. The Democratic version did not contain a net reduction in gasoline taxation the governor had desired and he promptly vetoed the bill in mid-March.

Democratic state treasurer Bill Lockyer supported the veto, saying his Party's version of the diversion plan did not do much to reduce the deficit and was legally questionable.[111] Common wisdom after the governor had made his January budget proposal was that the fiscal situation—combined with the 2010 political year—would lead to a prolonged summer stalemate. Virtually no one thought there would be a budget in place on July 1.

Common wisdom proved correct. At best during the remainder of fiscal 2009-10, there was a nostalgic reminder for when a difficult budget deal had been reached in the past. The John F. Kennedy library awarded "Profiles in Courage Awards" to the four legislative participants who came to an accord in the February 2009 budget deal. The award celebrated the participants for "standing up to the extraordinary constituent and party pressure" the deal provoked. [112]

But there were ironies in that award. That deal was a re-do of an earlier September 2008 deal that all participants had to know was unsustainable. Both GOP legislative leaders who went along with the February agreement lost their leadership positions as a result. And the February deal itself came unglued, partly due

to voter rejection of propositions that were part of the accord. It, too, then had to be redone.

Pressures to make some budgetary progress were not totally absent, however. The U.S. Supreme Court declined initially to reverse a lower court ruling that California undertake a major prison population reduction. Governor Schwarzenegger mused at one point about housing illegal immigrant prisoners in Mexico so save money. But the idea was quickly dismissed by his staff as "just something the governor thought was interesting." [113]

Later, the Schwarzenegger administration came out with a more thought-out plan to have UC oversee prisoner medical care, a plan that was said to save money. But given the risks entailed for UC, the Regents sent the plan to a committee for study. Regent chair Russell Gould indicated that the Regents would "have to spend a great deal of time" pondering the idea.[114] By mid-June, the U.S. Supreme Court had also decided to ponder the prisoner issue; the court now accepted an appeal by the state of the lower court order mandating a reduction in the state prison population.

State treasurer Bill Lockyer warned that lack of budgetary action would could it difficult to sell state bonds and thus hamper implementation of job-creating public works. As noted earlier, however, the fact that financial markets seemed willing to absorb California paper, despite these misgivings, undoubtedly weakened the force of the warning. More seriously, the possibility resurfaced that state workers would be paid only the federal minimum wage if there were no budget on July 1.

The minimum wage issue had arisen in 2008, during the budget stalemate that year, but was fended off with litigation. No one was actually paid at the minimum during that episode. However, when that round of litigation concluded, state controller John Chiang, who had resisted cutting pay in 2008, essentially had lost on all but one legal point. That one point—later to prove crucial—was that the state's antiquated computers might be unable to accommodate the pay change, or be able to do so in a manner that would comply with federal labor law.

There were also political diversions during the first half of 2010 in the form of the June primary that would determine the final candidates for the November 2010 elections. As time passed, more and more TV political advertising appeared. The ads initially were heavily the product of self-funding by Meg Whitman, the billionaire former CEO of eBay who was running in the Republican gubernatorial primary.

In the contest for U.S. Senate, the action was also on the GOP side since it was clear that the Democratic incumbent, Barbara Boxer, would be re-nominated. As might be expected, there was less focus on California's budgetary issues in the Senate race than in the gubernatorial contest. But at one point, Republican primary candidate (and eventual nominee) Carly Fiorina criticized rival Tom Campbell for his one-time role as Governor Schwarzenegger's director of finance, notably in the so-called "Demon Sheep" YouTube video that went viral.[115] The ad showed a sheep with glowing devilish eyes, presumably standing for Campbell—the wolf in sheep's clothing.

Fiorina also created a stir by seeming to say a state bankruptcy was "a possibility" that "should always be considered."[116] It was quickly pointed out that there is no legal mechanism for a state bankruptcy. Yet, oddly enough, Democrat Jerry Brown—who might have capitalized on Fiorina's statement—himself used the B word in public in March. [117]

Two corporations—PG&E, the Bay Area utility, and Mercury Insurance—financed expensive campaigns for propositions on the June ballot related to their industries (Props 16 and 17). Both of those initiatives were eventually rejected by voters. And as part of the

February 2009 budget compromise, the legislature was reluctantly forced to put on the June 2010 ballot a proposition that would create "open" primaries (Prop 14). Proponents believed that such non-partisan primaries would yield more centrist candidates—perhaps avoiding budget stalemates. Both major parties—as well as third parties—opposed the concept. But in June the proposition passed.

As noted above, because of the lack of an active primary race for governor on the Democratic side, much of the advertising and debating came from the GOP. Insurance commissioner Steve Poizner, who eventually became the main opponent to Meg Whitman in the primary, had in 2004 supported lowering the supermajority requirement for educational parcel taxes from two-thirds to 55%. He moved to the right in the primary, so that all talk on the GOP side focused on promising no tax increases. Indeed, candidate Steve Poizner proposed a 10% cut in income, sales, and profits taxes. Whitman offered "targeted" tax cuts for business and elimination of state taxation of capital gains. Of course, governors cannot by themselves cut taxes without the support of the legislature or, alternatively, by initiative.

Democrat Brown did not offer tax cuts. But he pledged no tax increases although in a more qualified way. He would not propose a tax increase. But if voters approved one—something that could happen via initiative or through a proposition put on the ballot by the legislature—that was another matter. Brown's stance on no new taxes unless voters approved them became part of his campaign message in the general election.

Despite the lack of effective opposition to Jerry Brown on the Democratic side, his fiscal record in his previous terms as governor ultimately became part of the campaign. Brown had run for President several times; in 1992, he had supported the so-called "flat tax," an idea with some similarity to the value-added type of tax that the now-defunct Commission on the 21st Century Economy had proposed for California. A Brown campaign spokesperson was vague on whether he now supported such a tax for the state. [118]

In California, the state income tax is progressive. Indeed, the state's heavy reliance on higher income recipients is the source of proposals to flatten the tax system, or rely more on the sales tax or a value-added tax. Since incomes at the top are volatile, so—too—are related state revenues. But although the income tax is progressive, there are many other regressive elements in state and local taxation, especially the sales tax. It is possible for California to rely heavily on higher income individuals for revenue *and* have a net regressive tax system at the same time. But fixing regressivity by adding more progressivity adds to volatility. And fixing volatility adds to regressivity.

That is the economic dilemma surrounding the flat tax. But there is also a political dilemma. Support by Brown for a flat tax in 2010 would have tied him to Governor Schwarzenegger. But Brown wanted Whitman tied to the governor, who was originally elected as a non-politician in the 2003 recall. According to Brown, who became a formal candidate in early March, "some people say… we need to go out and find an outsider who knows virtually nothing about state government. Well we tried that and it doesn't work."[119]

Both GOP candidates—Whitman and Poizner—by that time were distancing themselves from Schwarzenegger. But Whitman especially was emphasizing her business background and her lack of previous connection to state politics. [120] (Indeed, major gaps in her voting record as a private citizen had become campaign issues.) Brown pursued the theme of Whitman as another Schwarzenegger in a TV ad aired in October 2010 showing clips of the two using the same words. The mantra that "we don't have a revenue problem; we have a spending problem" was common to both.
The issue of an outsider coming to Sacramento to shake up the dysfunctional budgetary process did

tend to tie Meg Whitman to Schwarzenegger. Yet Steve Poizner, even though he was already in political office, emphasized his business/outsider past. Brown, on the other hand, questioned the idea of sweeping changes as the naïve view of outsiders. “Fundamental change of oneself, one’s body, one’s spirit or in the body politic is a mistake… (I)ncremental change consistently worked on is the way forward,” he said. [121]

While political drama was occurring for statewide executive offices, there was little budget action—even incremental—in the legislature which seemed preoccupied with other matters. The Assembly, for example, passed a resolution against cursing in public. But there was more activity in the streets. An early March student-faculty demonstration against the earlier tuition hikes at UC-Berkeley led to vandalism and some arrests. There were also related arrests at the state capitol. Other groups also demonstrated from time to time.

Although there was not much action within the legislature on the budget, Legislative Analyst Mac Taylor began to turn out reports on various aspects of the governor’s January proposals. With regard to natural resources, environment, and related infrastructure, the LAO expressed various concerns about how proposed water bond revenues would be managed. (The water bond had not been postponed to 2012 at that point.) He also noted that what the governor called a “fee” for fire fighting was in reality a tax, thus requiring a two-thirds vote. It would also indirectly trigger more spending on K-14 education pursuant to Prop 98. [122]

With regard to transportation, the LAO viewed Caltrans as overstaffed in some areas. It questioned the legality of the governor’s push for public-private partnerships due to the use of federal funding for that purpose. And the LAO urged more legislative oversight of the High Speed Rail Authority, which would be receiving federal stimulus monies. [123]

According to the LAO, the legislature should restore state funding to UC and CSU to the 2007-08 level, a level less than the governor’s proposal. Community college tuition should be raised. Cal Grants to qualifying low-income students should not be cut. [124]

At the K-14 level, although the governor’s budget nominally complied with Prop 98, there were questions about whether such compliance was actually possible and about the legal interpretations surrounding Prop 98. The LAO suggested an explicit suspension of Prop 98 or some other adjustments to insure legal compliance.[125] Relief for local school districts from mandated programs so that they could allocate state-provided funds more flexibly was also recommended.[126]

For health and social services, in some respects the LAO mirrored complaints by the governor about federal and court constraints on state budgetary options. On one hand, the state should seek more flexibility. But on the other the reality for California was heavy dependence on federal funding and regulation.[127]

These reviews by the LAO received media attention but exactly what impact they had on the legislature is unclear. And the media were already more enmeshed in the political campaigning—particularly by the time Brown officially declared—than concerned with the intricacies of a budget that wasn’t going anywhere.

Absent progress towards a budget, public attention focused on symptoms of the budget dilemma. Oddities in the results of the furloughs ordered by the governor were detected, including the situation of workers who received furlough-related pay reductions, but who were unable or not allowed to take the time off. Their furloughs in effect became “banked” for future use which could lead to *de facto* paid leaves in the future.

As noted, those who did take furlough time off tended to take less formal vacation time, thus growing their bank of unused vacation which would eventually have

to be paid. The main furlough problem, however, was the uncertain legality of the program; the governor was winning some lawsuits on the issue and losing others. An eventual verdict by the California Supreme Court of illegality could trigger back pay, although it was clear that such a decision would not be forthcoming with finality during fiscal 2009-10. [128] (And when it came during 2010-11, the furloughs were upheld.)

There were other oddities and consequences developing, apart from those associated with furloughs. Depletion of cash available to provide bridge loans for public construction led to delays in such projects, a perverse result during an economic slump. Voter-approved bonds have to be floated on an orderly schedule. Absent such bridge loans, projects could not begin until there was actual bond money on hand.

UC-Berkeley indicated it would take more out-of-state students who pay higher tuition than in-state residents for budgetary reasons. UC-Davis dropped certain team sports. At the community college level, for-profit Kaplan University advertised to students that it could offer courses that were becoming unavailable at the public institutions. Yet polling data suggest that almost nine out of ten California parents want their children to attain at least a college degree. [129] And employers were expressing concern about the impact of a deteriorating K-12 and higher education system on the state's workforce. [130]

Delays in college acceptance were also developing; both UC (except UCLA and UC-Merced) and CSU began using wait-lists for students since the budget that would be provided to higher education was uncertain. For stray pets, however, delays were shortened. A state-mandated requirement that stray animals in local pounds be kept alive for an extended period went unfunded, leading to shorter times to euthanasia.

Despite the symptoms of fiscal distress, there was a tendency in the legislature to wait until the May revise before even considering major budget issues for 2010-11. The economy had at least bottomed out and the Legislative Analyst issued an interim report pointing to the somewhat improved economic outlook. It was more tempting to look at the bright side of that report and neglect its warning of a long-term structural deficit that had to be addressed.[131] However, in the period immediately after the Analyst's report, the legislature did pass some mid-year deficit cuts, mainly through a diversion of transit funds to the general fund. These cuts were combined with some tax breaks for green businesses and first-time homebuyers. Transit operators, while not happy with the diversion, basically agreed to it as better than other proposals on the table.

The problem was that every plus for the budget seemed to be accompanied by a minus. A court decision allowed the state to divert funds from local redevelopment agencies. But the governor dropped his plan for funding from offshore drilling after the BP oil spill in the Gulf of Mexico. By that time, poll data showed strong public opposition in California to such drilling.[132] April tax collections were below estimates made in the January budget proposal. New federal funding was secured but also less than what had been estimated (or perhaps "demanded" would be a better term) by the governor in January.

## REVISE AND DISSENT

*"I now have no choice but to stand here today and to call for the elimination of some very important programs. If we had reform in place we would not be facing the 'Sophie's Choice.' (E)very time we talk about reform, the lawmakers don't have any interest to really do those reforms. The special interests shout that we're balancing the budget on the backs of the poor and at the same time they push the lawmakers to drain the budget when we have spikes in revenues and then scream for tax increases when we fall short on revenues."*

—Governor Arnold Schwarzenegger [133]

*"I am disappointed that the Governor has chosen to surrender. That he sees California as unfixable and that he proposes a budget that kills the economy and harms so many. It is a non-starter. If God forbid this budget became a reality, California would be the only state in the union to not have a safety net for children. Leadership is not about blaming others. It's about finding solutions to tough problems to preserve the state and its people."*

—Senate president Darrell Steinberg [134]

*"What I said to the governor in just a hallway exchange was, 'You better be glad I'm not here, because I'd have my members send you the document you sent to us, which is not implementable.' It's clearly designed for refinement. You give him his original document, and he'll jump off the bridge."*

—former Assembly speaker Willie Brown [135]

Amidst the rhetoric surrounding the May revise proposal, the basic issue—as noted previously—was obscured. The governor proposed a plan that would, given his estimates, lead to a positive reserve of about $1 billion at the end of fiscal year 2010-11. But the reserve at the end of 2009-10, the year that was soon to conclude, was estimated to be roughly -$8 billion if nothing further were done for that year. So the governor wanted the end-of-year reserve to rise by a net $9 billion. (-$8 + $9 = +$1)

However, the workload budget for 2010-11—what would happen if nothing further were done—was in deficit by about $10 billion. What the governor wanted was a fix totaling around $19 billion. By his calculation, that would have resolved all current *and past* budgetary sins by the end of fiscal 2010-11. More specifically, what the governor was proposing was about a $1 billion reduction in the 2009-10 budget and cuts of $10 billion in the 2010-11 budget just to bring it into balance (income = outflow), and still more cuts in 2010-11 of about $8 billion to correct the remaining past sins.

When the issue is posed as above, distinguishing present from past and stocks from flows, the question can be looked at differently from the way it was presented by the governor. Specifically, the issue becomes how much past sin was it necessary to correct *within* 2010-11. For the governor, not correcting all of it was irresponsible or at least a legacy that he did not want to leave to the next governor. But that was not necessarily the way legislative Democrats saw it. What the governor viewed as "kicking the can down the road" (not ending with a positive reserve of $1 billion) was seen by them as a multiyear approach (essentially borrowing internally and externally during 2010-11 as part the budgetary solution).

To keep the 2010-11 budget in balance and correct past sins would require either a substantial gain in revenue or substantial cuts. The governor had taken a stance on no new taxes so the emphasis was on cuts. But as in January it may have been that by proposing drastic cuts, he was still hoping to pry more aid from Washington.

Perhaps the threat of major cutbacks in social welfare programs such as Medi-Cal, home service aides, and CalWorks was designed to shock Washington into providing more support. If that was the goal, however, the added funds were not produced. But, as might be expected, the proposed cuts triggered strong resistance from legislative Democrats.

Even Republicans were reticent. GOP gubernatorial candidate Meg Whitman she wouldn't have called for the complete elimination of CalWorks, but rather would have reformed it. [136] Similar sentiments were expressed by Republican Senator Roy Ashburn who thought the governor was just being "provocative" in making the proposal. [137] The Legislative Analyst indicated that it would be better to squeeze more money out of education at all levels than completely to terminate CalWorks. Yet various educational groups had filed suit shortly after the May revise challenging state funding of K-12 education. Their claim was that the state was not meeting its constitutional requirements to provide free public education.[138]

An additional issue was that the governor tied his eventual signing of a budget to reforms that had limited immediate effect on the budget. That is, in his final year in office, he may have wanted to leave a legacy as a reformer. Some of the threat to the Schwarzenegger legacy was effectively on the ballot in November 2010, but not something the legislature could directly influence. He had succeeded through a ballot initiative in 2008 to take redistricting out of the hands of the legislature (after failing in 2005). However, Prop 27 was put on the November ballot by another initiative and it would reverse the 2008 proposition, sending redistricting back to the legislature.

Related to reforms in voting was Prop 14 on the June 2010 ballot creating a non-partisan primary system for the legislature. Proponents—who vastly outspent detractors of Prop 14—believed that such a primary system would lead to more centrist candidates and legislators, and so persuaded the voters. A legal challenge was soon mounted. Among the proponents of Prop 14 was Governor Schwarzenegger.

The governor had developed an international reputation as an environmentalist by supporting state reduction of greenhouse gas. But Prop 23 on the ballot would suspend key legislation—AB32—that would implement that reduction. Apart from ballot issues, the non-partisan primary that voters passed in June 2010—part of the budget deal of February 2009—was challenged in court. The governor was a supporter of the non-partisan approach, but there was nothing that budget negotiations could do to deal with these legal challenges to the Schwarzenegger legacy.

Another goal of Governor Schwarzenegger in the past was creating a "rainy day" fund to smooth out budget fluctuations. In 2004, as part of the budget workout of that era, Props 57 and 58 were passed by voters. A rainy-day fund of sorts was created. But in reality the general fund always has had a reserve and creating a second reserve essentially added little. Whether the governor would insist on yet a third reserve—or a modification of the earlier rainy day fund—with some tighter formula as part of a budget deal was unclear.

However, the governor did express a clearer desire for pension reform. All three major state pension funds, CalPERS, CalSTRS, and UC, had become underfunded. As part of his abortive "Year of Reform" initiative package in 2005, the governor had originally included a pension-related proposition. But it was dropped and never appeared on the ballot because of technical language problems that seemed to target the widows of public safety officers. (And had it appeared on the ballot, it almost certainly would have been swept to defeat with the other 2005 initiatives the governor had pushed.)

## A PENSION DIGRESSION

*"Our pension crisis… will continue to grow and crowd out funding for programs and services Californians hold dear such as higher education, parks and environmental protection."*

—Governor Arnold Schwarzenegger [139]

Public pension issues became more pressing by 2010, thank in part to the 2008 financial collapse which led to major declines in the stock market. These declines affected not only state public pension system but also local government pensions maintained by various jurisdictions. The issues of pension funding are complex. But a few elements are worth reviewing here.

Public pensions tend to be of the "defined-benefit" type. Defined-benefit plans provide a monthly pension on retirement that is based on a formula, typically involving age, length of service, and pay history. Good management of such pensions requires setting a formula that is not susceptible to gaming by employees; such gaming is known in the field as pension "spiking." If the pay history covers only a

short period before retirement, and if that history is allowed to include such things as overtime pay, employees may be able to inflate their final earnings and thus qualify for a pension out of line with their true past earnings history. Some public pensions in California were susceptible to spiking.

Good management also involves the funding side. Employees are accruing pension promises annually as part of their pay packages for current services. If employers do not put aside adequate funds to provide for those promises at the time the promises are earned, then—in effect—services of public employees today are being charged to the future, a bad practice. Future taxpayers, who were not necessarily the recipients of those services, will be paying for the compensation of retired employees who worked earlier.

Pension experts have a concept—the "normal cost" of a defined-benefit pension—which can be thought of as the amount needed to be put aside today to pay for today's promises when those promises eventually come due. Part of the calculation of the normal cost involves the expected rate of return of the pension fund's investments. Since the future rate of return cannot be known with certainty until it occurs, it is possible for pension funds to become underfunded or overfunded even if good-faith estimates of the normal cost are put into the pension trust.

Good practice, however, is to keep contributing the normal cost to the fund, even during periods when pensions appear overfunded, since investments—particular stocks—can go up and down in value. California public pensions were given increased latitude to invest in stocks through a legislative ballot proposition in 1984. If underfunding becomes pronounced, good practice involves "amortizing"—paying off the gap in installments over a period of years. Thus, the contribution to the fund—usually a combination of employer and employee contributions—should be the normal cost plus any needed amortization.

Suffice it to say that public pensions in California were not always managed according to these good practice rules, although the degree of departure from the rules varied with the particular fund. The legal status of retiree and employee claims against public pension funds in California is pretty ironclad; once benefits have been earned, they cannot be taken away retroactively. Thus, pensions of already-retired employees cannot be cut. And the prior accruals of active employees are also protected.

However, public employers—including the state—can legally terminate pension plans, ending future (but not past) accruals. New hires can be given lesser benefits (or even no benefits). Active employees can be given lesser benefits *going forward* or, as just noted, even no further accrual of benefits.

Governor Schwarzenegger appeared to favor some version of such a "two-tier" approach, i.e., a degraded pension for new hires and for active employees going forward. Various options fall into the two-tier category. One version could be a new, but less generous, defined-benefit pension. Another—explicitly favored by GOP gubernatorial candidate Meg Whitman—would offer as a second tier a "defined-contribution" plan. Under such a plan, the employer simply puts a defined amount—say a fraction of the basic wage—into a tax-favored savings account for the employee. The employee is left to invest the money in various funds offered by the employer, e.g., a stock fund, a bond fund, etc.

Since the employer has not promised more than the current contribution, a defined-contribution plan—by definition—cannot be underfunded. However, what the plan would end up offering as a retirement income would depend partly on what rate of return the employee had achieved. He/she could take the cash accumulated upon retirement to a commercial insurance company and buy a monthly annuity that would pay a specified benefit for life. How much the accumulated cash would buy would depend on such factors as the

rate of interest at the time of retirement. In short, moving from defined benefit to defined contribution shifts a major risk from the employer to the employee.

Even if the state were to adopt some version of a two-tier pension system, it would still owe benefits under the old plans to retirees. And it would still owe active employees what they had accrued under the terms of the old plan up to the date that the lower-tier plan was substituted for the old one. Thus, the annual budgetary savings of going to the two-tier approach are limited.

Moreover, other things equal, two tier is a cut in pay for those affected. During a weak economy, that may not pose an immediate problem, since recruitment of new employees is limited and current employees are less likely than in good times to quit. But should prosperity return, cuts in pension benefits might have to be offset by other forms of pay. The bottom line is that pension reform would have only a limited effect on the 2010-11 budget and its savings in the future might be less than its proponents may think.

It was not clear what the governor would view as a sufficient step to count as a reform legacy in the pension area, although some general elements emerged. Following the May revise, he signed contracts with various state unions which raised employee contributions to their pensions and create a second tier for new hires. In a *Wall Street Journal* op ed, he suggested that more would be required for him to sign a budget. But some of what he seemed to want might require constitutional amendments which could not be on the ballot before the governor's term expired. [140]

Earlier, he had used strong language saying that needy recipients of state services were being "robbed blind" by public pensions. [141] Yet while this rhetoric was being uttered, a trial balloon was leaked from the governor's office suggesting that the state might in some way "borrow" from CalPERS.[142] Not surprisingly, that possibility was quickly abandoned. Whatever the explanation, complaints about pension underfunding and proposals to borrow from the same pension plan did not go together.

In any case, in the union contracts that were signed, the lower-tier retained the defined-benefit format and did not affect future accruals of existing workers. The unions that made these deals may have felt it was best to sign with the current governor. The uncertain alternative was to await either Meg Whitman—known to favor a more drastic two-tier approach with the lower tier being defined contribution—or Jerry Brown who had a mercurial reputation. Whitman exempted only public safety workers from her defined-contribution approach—except for prison guards whose union endorsed Brown.

The pension question became both a political issue in the 2010 gubernatorial election campaign and an element of the eventual budget deal reached in October 2010 regarding the 2010–11 budget. Governor Schwarzenegger had—as noted—made some kind of pension reform a "legacy" issue and insisted that he would not sign a budget without such reform. An eventual deal between the administration and SEIU Local 1000 (a key state worker union), became what the Governor seemed willing to regard as sufficient. The deal included higher employee contributions to CalPERS and a defined-benefit plan lower tier plan for new hires.

After the budget was signed, the governor criticized certain Republican legislatures by name for not going along with the pension deal in his weekly radio address of October 15, 2010. The YouTube version of the address included photos of the errant legislators. The pension matter also entered the gubernatorial race through the "whore-gate" controversy. Candidate Jerry Brown called a representative of a police union trying to enlist support and left a voicemail message. He did not properly hang up the phone and the voicemail picked up subsequent talk among Brown and other aides.

One of the aides called Whitman a "whore" on the recording for accepting police union support in exchange for deviating from her plan for creating a lower tier defined-contribution pension for state workers. As indicated, she supported an exception, allowing defined benefits for police. Although the matter surfaced as an insult to women for which Brown apologized, he rather inarticulately made the allegation of exchanging police union support for retaining defined contribution at a TV debate. Perhaps more surprisingly, Governor Schwarzenegger criticized Whitman for just such a political exchange in a Twitter note.

In any case, the immediate budget crisis was leading to more pension underfunding, not less. CalPERS had proposed a large increase in employer contributions to the fund but postponed the request shortly after the May revise was presented. The UC Regents authorized a restarting of employer and employee contributions to the UC pension plan in April. But they were unable to obtain funding from the state so the employer share was deducted from other elements of the university budget.

Moreover, absent state funding, the UC restart was itself underfunded and below the Regents own policy toward pension funding. In September, they boosted contributions but, again, still to a level below their own policy. At this writing, the Regents planned to come up with a two-tier defined-benefits approach by the end of calendar 2010.

## SUMMERTIME AND THE BUDGET IS QUEASY

*"They always start late, therefore they always will be late."*
—Governor Arnold Schwarzenegger [143]

*"The budget will not be written behind closed doors in 'Big Five' meetings."*
—Assembly Speaker John Pérez, after being sworn in to the Speakership [144]

*"(Budget proposals) are the exact kind of things you can't discuss in public. That's what makes them evaporate. Once you get to resolution you can talk about it but not before. It's the greatest way that you undermine the ability to get to resolution."*
—Assembly Speaker John Pérez, after two weeks into the 2010–11 fiscal year with no budget in place [145]

On July 1, 2010, as virtually all observers had long predicted, there was no budget in place. Nor was there much sign that a budget would be enacted any time soon. The governor mounted a deficit "clock" outside his office that purported to show the daily deficit accruing as each day with no budget passed. (In fact, since budgets can apply retroactively, and since receipts and expenditures are seasonal, it is not possible to attribute a precise number to a given day.) And despite claims that transparency required avoiding private discussions among the Big-5 (the governor and the four legislative leaders), there were on-again/off-again Big-5 meetings and consultations (that apparently produced no results).

Governor Schwarzenegger initially had the minimum wage threat available; state workers would be paid the federal minimum until a budget was enacted. (Then they would receive the total salary due.) Attempts by Democrats in the legislature to make the state payroll a "continuing appropriation"—which would have ended

the threat—were unsuccessful. But the arguments in court of state controller John Chiang soon thwarted that threat.

Chiang argued—as he had in 2008—that the state's payroll computers couldn't handle the cut to the minimum (and the subsequent reimbursement for lost pay after a budget was in place) within the legal bounds of federal labor law. A court refused to force Chiang to implement the cut, pending a full hearing on that issue. The refusal effectively pushed the minimum wage issue off the table through the end of the legislative session on August 31st and beyond.[146] However, some state labor unions did sign contracts with the governor which potentially would exempt them from the minimum wage—assuming the legislature approved the deals. So the minimum threat seemed to be more effective in collective bargaining than it was in the budget realm.

Once the court decision took away the minimum threat, the governor found a new bargaining chip. Furloughs were to end with the expired 2009-10 fiscal year. The governor announced new furloughs to be in force until a budget was enacted. By that time, various furlough-related legal cases had reached the state Supreme Court, although no final decision had been reached. Thus, the continued furloughs became a substitute lever for the governor.

Governor Schwarzenegger had a setback in court which prevented a resumption of furloughs in July but eventually his authority was at least temporarily restored while the issue went to the state Supreme Court. In various interviews, he insisted that with the budget must come various reforms—notably in the public pension area. And he threatened that if there were no reforms, the budget impasse might last until his term ended and a new governor took office.

Democrats pushed for a delay in various business tax breaks that were due to start on January 1, 2011 under the terms of the February 2009 budget deal. But that would require Republican votes which were not forthcoming. And in any event, a proposition on the November ballot (Prop 24) would repeal those breaks.

There was also a complicated scheme involving borrowing from the Beverage Recycling Fund and paying back the Fund with an oil severance tax. Their approach was supposed to avoid the two-thirds vote requirement but it was legally dubious. Indeed, Democratic gubernatorial candidate Jerry Brown—in his role as attorney general—said the plan was illegal. Given the uncertain legal issue, it was unlikely that buyers of bonds issued on the basis of the scheme could be found, if it were somehow enacted.

Another tax plan by the Democrats involved raising certain taxes that could be deducted from federal income taxes—mainly the state income tax—and providing partially offsetting tax cuts elsewhere. The argument was that the net effect, once the federal deductions were factored in, was that Californians would come out ahead. There was some dispute over the impact. The LAO found that not all tax brackets, particularly those covering folks in the middle-income range, would produce net benefits. That is, middle-income taxpayers would typically experience a net increase in taxes. In any event, the impact would vary from taxpayer to taxpayer.

It appeared that part of the debate was over whether to make the comparison with current taxes or with the taxes that would be paid once the February 2009-enacted temporary increases lapsed. Senate president Darrell Steinberg insisted that the current comparison was the relevant one to make, even though voters in May 2009 had rejected extending the February 2009 increases. In any event, coming out ahead when federal deductions are factored in does not void the two-thirds vote requirement. And Republicans seemed unlikely to provide the needed votes.

There was also discussion of pushing responsibility for some social welfare programs—"realignment" was the term used—from the state to the counties, although how the counties would fund the programs was unclear. Candidate Brown seemed to favor the idea, saying that at the state level government had become "constipated and overloaded with too many conflicting mandates." [147] Odd ideas surfaced from the legislature. For example, one bill was approved by the senate and sent to the assembly which would have allowed digital advertising on car license plates as a way of generating revenue.

Meanwhile, the June primary had brought the gubernatorial contest—and other statewide contests—effectively down to two candidate races, one Republican and one Democrat. Of interest for budgetary reasons was the Insurance Commissioner race on the GOP side. Former Assembly minority leader Mike Villines had lost his leadership position because he went along with the February 2009 budget compromise. He ran in the Republican primary for Insurance Commissioner against a virtual unknown who did little campaigning. Immediately after the June 2010 primary election, it appeared that the unknown candidate had narrowly won. Later, once all ballots including absentees were counted, Villines had eked out a narrow victory. Nonetheless, it was clear that Villines' near loss in the primary was due to compromising on the budget, a message Republicans in the legislature surely recognized.

Neither Jerry Brown nor Meg Whitman in the gubernatorial race had kind things to say about Governor Schwarzenegger. As a result, the governor withheld endorsing either candidate in the general election. Indeed, he pronounced GOP candidate Whitman's call to cut state employee jobs by 40,000 "bogus." [148] But he conceded when pressed in an interview that his eventual endorsement for a successor would be a Republican (and Whitman was the only Republican). [149] With Whitman continuing to blame the budget situation on the legislature and governor collectively, Schwarzenegger remained silent as to any endorsement. At this writing, no endorsement had been made by the governor.

Initially, after the primary, Brown seemed to revert to his 1970s off-beat persona, making statements such as that "the fundamental quest is how do we touch our spirituality." [150] He emphasized incrementalism rather than specific grand plans for the budget or anything else, talking about an "agenda of humility," a phrase that harked back to the "small is beautiful" approach of his earlier governorship.[151] Whitman had issued a booklet before the primary with a general plan which Brown dismissed saying "She doesn't have a plan. She has a pamphlet, and most of it is pictures."[152] But later he began to issue more specific plans of his own.

Whitman continued to outspend Brown on campaign advertising, mainly TV and radio, by a large margin. She criticized both the legislature and the governor for not producing an on-time budget. Since Brown was dependent in large part on union support—financial and indirect—she tried direct appeals to unionized workers individually such as nurses. But to the extent that Brown allies were able to do so, they continued to raise her Wall Street connections and her sparse voting record as a private citizen. Also surfacing was an incident at eBay where Whitman apparently had an argument with an employee and shoved her, leading to a lawsuit and a significant monetary settlement with the employee.

There was not much direct critique in the anti-Whitman advertising about her particular budget priorities. Indeed, some of the critique she received was from the right—not through advertising but through talk radio. Arizona had passed a law aimed at preventing illegal immigration that had become controversial. Whitman was viewed by some on the right as insufficiently tough on illegals because she did not endorse similar approaches for California.

More generally, conservative Republican congressman and former state legislator Tom McClintock referred to a possible Whitman victory as "Arnold Schwarzenegger's third term," a description not meant to be a compliment. [153] (McClintock—as a state legislator—was known for voting against all enacted budgets.) He continued his critique after she won the Republican primary and did not endorse her.
For the general public, however, the absence of a budget or even the cuts in the prior budget had little day-today effect. Only those particularly dependent on state services felt the effect. CSU, for example, raised summer 2010 tuition and then tuition for fall 2010.

From time to time, items would appear in the news media about particular programs being threatened—such as mammograms for poor women or Cal Grants for community college students—or about peculiar results occurring. [154] For example, in the past under the Williamson Act, a program existed to preserve agricultural land from development through state-funded property tax reductions to farmers. The program was administered by counties that would normally receive funding from the state. But the governor had used a line-item veto cutting the program to $1,000 total. So the media reported that counties were receiving checks from the state for as little as one cent as their shares of the $1,000 total.

The IOU threat was periodically raised by the controller and others. In a sense, IOUs were again issued during summer 2010. When there is no budget, suppliers to the state go unpaid and various public programs go unpaid. So the state saves cash by not paying bills on time and thus owes the funds both to private and public entities. Various health providers received a form of IOU in the late summer. But the state did not return to issuance of Registered Warrants during the summer and the controller indicated that the various other deferrals of payments would stave off issuing such warrants until at least October. [155]

In effect, the cost of not having a budget in place to the political actors was low. Academic research across states suggests that when these costs are low, the probability of late budgets rises.[156] California was a poster child for that premise in the summer of 2010. Even the fact that the legislative session technically ended on August 31 did not produce budget progress. Votes were taken on Democratic and Republican versions of the budget with both sides knowing that absent a two-thirds vote neither would pass.

The governor had announced that he would call a special session to deal with the budget beginning September 1, so all participants had every reason to think the budget would remain a live issue. As it turned out, he did not immediately call such a session. Instead, he held a press conference on September 1, much of which was focused on the pension issue. He insisted that even though there appeared to be no more Big-5 sessions going on, some kind of behind-the-scenes contacts were occurring and that really all sides were "very close" to a deal, held apart only by special interests and election politics. [157] But since no deal emerged, he took off on a scheduled trade mission to Asia. Big-5 meetings took place on his return—with a renewed promise that a deal was in the offing.

## PROPOSITIONING THE VOTERS

*"These two initiatives are Exhibits A and B as to why the initiative process needs to be reformed."*

—State Senate president Darrell Steinberg, referring to Props 22 and 26 [158]

By mid-July, the propositions that would appear on the November 2010 ballot were assigned numbers and the ballot analyses and arguments were published. Some of the propositions had budgetary implications. As noted, a water bond was originally on the ballot

but was removed by the legislature, fearing that voters would not pass it in the midst of an economic slump. Prop 19 purported to legalize marijuana—not just "medical" marijuana—a flat collision with federal law. Part of the argument for Prop 19 was that legalized marijuana could be a source of tax revenue. One ad suggested there could be "billions" in revenue—a bit of a stretch, albeit no time period was mentioned. Prop 21 added a motor vehicle fee of $18 per annum earmarked for state parks. The pro side added the enticement that California-registered cars would receive free admission to those parks. Prop 22 tightened prior constitutional language to prevent the state from raiding the treasuries of local governments and transit agencies. However, not all local governments were sold on the idea; counties that were heavily dependent on the state were concerned that tying the state's fiscal hands would lead to less funding for them. Prop 24 was a repeal of the business tax breaks included in the February 2009 deal and slated to go into effect beginning in 2011.

Prop 25—opposed by Governor Schwarzenegger—dropped the two-thirds vote requirement to pass a state budget to a simple majority. Opponents objected to the title which explicitly noted that the two-thirds vote requirement on taxes would not be touched. They raised issues related to whether Prop 25 might indirectly allow majority votes on taxes. However, an attempt to obtain a court-ordered title change failed. Going in the opposite direction, Prop 26 went in the opposite direction, adding a two-thirds vote requirement for increasing state fees. Proponents argued that a loose distinction between a fee and a tax had allowed the legislature to engage in *de facto* tax raising by majority vote.

While the implications (or outcomes) of these various propositions for future budgeting is not clear at this writing, their presence on the November ballot added to a climate of fiscal uncertainty. For that matter, the fact that 2010 was a gubernatorial election year was also a source of uncertainty. Fear of the unknown might conceivably have spurred budget negotiators to complete their business over the summer. But it did not appear to have that effect.[159]

**Table 6: Registered Voter Views of the California Economy, September 2010**

| | |
|---|---|
| California voters Characterizing the Economy as "Bad Times" | 93% |
| Voters Expecting the Economic Situation to Worsen or Stay the Same | 66% |
| Voters Characterizing Unemployment in California as Very Serious | 89% |
| Voters Expecting Job Situation to Worsen or Stay the Same | 65% |

Source: California Field Poll, http://field.com/fieldpollonline/subscribers/Rls2360.pdf

The approach of Election Day, however, did seem to encourage a renewed attempt at deal-making which culminated in the budget accord—however shaky—described in the next section. Much depended on how one might think lack of a budget would affect votes for Prop 25—the measure to reduce the votes needed to pass a budget to a simple majority. Republicans may have concluded that a continuing budget stalemate would increase the odds that Prop 25 would pass. A simple majority rule would likely weaken minority party power to block a budget.

For both parties, as **Table 6** shows, voters were in a sour mood due to the California economy. Almost all registered voters in September 2010 thought that the condition of the state's economy was bad and two thirds thought the situation would continue in the following year or even worsen. How this dark view would play out in the November election was unclear, but it was possible to paint scenarios in some legislative districts that would be unfortunate for one party or the other.

# THE FALL 2010 BUDGET DEAL

*"State legislators stalled on a new budget for a record 100 days… It didn't improve with age. The budget they enacted is a sick joke of phantom revenues and low-ball expenditures that will almost certainly fall apart in a few months."*

—Dan Walters, Sacramento Bee columnist [160]

*"…(A)s the economic recovery is expected to be slower than shallower than those of the past, the state will have a more difficult time growing its way out of the current negative balances."*

—Moody's Investors Service, commenting on the reserve in the general fund [16]

**Table 7: Enacted 2010-11 Budget Compared to Earlier Workload Estimate ($ billions)**

| | 2010-11 Workload Budget as of May 2010 Revise* | 2010-11 Enacted Budget Oct. 2010 With Vetoes |
|---|---|---|
| Revenue & Transfers | $89.3 | $94.2** |
| Expenditures | $99.5 | 86.6 |
| Surplus/Deficit | -$10.2 | +7.6 |
| Reserve at End of Year | -$17.9 | +1.3 |

*From Table 4.
**$1.4 billion of the increase relative to the workload estimate comes from adoption of a more optimistic forecast.

Source: Enacted budget estimates from Legislative Analyst's Office, Major Features of California's 2010-11 Budget, October 12, 2010. (This release first appeared without the governor's line-item vetoes and was revised after the vetoes were made.)

Although California's institutions have gradually adapted to delayed budgets—the government does not shut down when there is no budget in place—the costs do creep up. There were little annoyances—toilet paper in state park restrooms and outhouses was reportedly running out since suppliers weren't being paid. And there were bigger ones—$3.9 billion in transportation project spending was delayed to the point where fall and winter weather conditions (mainly rain) would cause delays in spending—even if a budget were suddenly to be enacted. [162]
As such problems accumulated in late September, word began to leak out of the budget negotiations that some kind of deal was close. Then a "framework" for a deal was announced. And finally an actual deal was concluded and legislative leaders patched together enough votes to pass the accord.

While this process was unfolding, the two gubernatorial candidates were hinting at what they would do about the budget and related issues. Both Jerry Brown and Meg Whitman seemed likely to take some kind of budget-oriented propositions to the voters through ballot measures. Brown threw out a number of ideas such as using final-offer arbitration in the legislature to determine whether the budget would be the Democratic or Republican version. [163]
He also suggested so-called zero-based budgeting (all programs start from zero and must be annually justified to continue). [164]

**Table 7** compares the pension agreement of October 2010 with the workload projection issued by the governor as part of his May 2010 revise. "Agreement" may be too strong a term because after the governor line-item vetoed over $900 million in spending, legislative Democrats suggested that he had not upheld their understanding. They vowed to restore at least some of the cuts, although such restoration would depend on cooperation of the governor who would take office in January 2011. One lawsuit challenging a particular veto of an expenditure of over $100 million for child mental health was filed. At this writing, there could be yet other such suits challenging either vetoes or other budget elements in the future.

There were also reports and denials that whatever understanding with the governor about vetoes existed had been voided by legislative failures to pass certain bills the governor wanted. [165] Just as there was

political retribution after the February 2009 budget deal, so, too, was there a reoccurrence in October 2010. In the later case, a Democratic legislator who voted against the budget deal—Senator Leland Yee of San Francisco—had his name stripped from a bill and was later removed from a leadership position.

Ostensibly, through a combination of revenue enhancements and budget cuts, the 2010-11 budget was not only "balanced" but ostensibly runs a surplus of over $7 billion, sufficient to end the fiscal year with a reserve of over $1 billion. However, the budget numbers were shaky. Of the revenue increase shown relative to the May workload budget, $1.4 billion was the result of a more optimistic forecast. About $1.8 billion was in fact borrowing from outside the general fund and another $0.9 billion represented enhanced estimates of asset sales (state office buildings). As noted earlier, borrowing and asset sales are not really "revenue" in a meaningful sense.[166] There were optimistic assumptions of $4.1 billion in federal support, some of which might not arrive. On the other hand, there was a suspension of a business tax break that would otherwise have cost over $1 billion.

There were real cuts—notably the line-item vetoes just mentioned—and a suspension of Prop 98 requirements for K-14 spending. Some cuts might not happen, however, such as a drop in prison medical care of $800 million that appeared to fly in the face of court orders to the contrary. [167] Although a pension deal was part of the governor's requirement for reaching a budget deal, there were no pension savings reported for 2010–11. His pension deal would have budgetary impacts only in the future. The future was clouded, however, by structural problems that included expiration of the temporary tax increases passed in February 2009. Indeed, there was a possibility that the new governor who took office in January 2011 would push for a reopening of elements of the budget for 2010–11 as part of the budget proposals that would have to be made for 2011-12.

# WHAT DO WE LEARN?

*"You can't win everything."*

—Governor Arnold Schwarzenegger, commenting on the budget deal and his legacy [168]

*"I'll probably make some new mistakes. But I'm not making any old ones."*

—2010 gubernatorial candidate Jerry Brown, on what he would do if elected [169]

Clearly, California was a state in dysfunction with regard to the budget and other matters of public policy. The usual suspects for this dysfunction are well known, although observers put different weights on the various elements. But they include institutional features such as ballot-box budgeting, supermajority requirements, gerrymandering, party polarization, and the amateurism brought about by term limits. Underlying the problem is an inability to make sufficiently rapid budget adjustments, as the economy fluctuates, to keep the budget reasonably balanced.

Budget problems were a key factor in the recall of Governor Gray Davis and his replacement by Arnold Schwarzenegger in 2003. Yet the new governor ended his period in office with a level of public disapproval comparable to Davis' at the time of the recall. Perhaps voters expect more of their governors than is reasonable. But it is also true that as governor, Arnold Schwarzenegger, tended to have an expansive agenda and an impatience for detail.

His ability to focus on solving the underlying budgetary institutions that brought him into office was insufficient to bring about major change within his two terms. The Schwarzenegger budgetary legacy may hang on the fate of his favored nonpartisan primary (passed by the voters but in litigation) and redistricting outside the legislature (whose fate in the hands of voters in November 2010 is unknown

at this writing). Proposition 25—dropping the votes needed for a budget from two-thirds to a simple majority—might affect the decision time for budgetary enactment. But since Governor Schwarzenegger opposed it, it cannot be part of his legacy, even if passed. A new governor will take office in January 2011 and face an immediate legacy of a budget still in short-term and long-term distress.

# ENDNOTES

**1** Quoted in “Not Sure He’s Joking,” *California’s Capitol*, May 22, 2009. This chapter relies heavily on news sources such as the *Sacramento Bee* (including its *Capitol Alert*), the *Los Angeles Times*, the *San Francisco Chronicle*, and associated and independent news blogs. In general, only direct quotations are cited due to space limitations.

**2** John B. Judis, “End State: Is California Finished?” *The New Republic*, October 26, 2009.

**3** Quoted in Kevin Yamamura, “Schwarzenegger Wishes He Could Run for Third Term,” *Sacramento Bee Capitol Alert*, April 26, 2010..

**4** Quoted in Michael Grunwald, “Despite Its Woes, California’s Dream Still Lives,” *Time*, October 23, 2009.

**5** Erik P. Bucy and Michael J. Ensley, “Issue Benefactors or Issue Victims? Ballot Initiative Influence on the Vote for California Governor, 1982-1998,” *California Journal of Politics & Policy,* vol. 1, no. 2 (2009).

**6** Joe Mathews, *The People’s Machine: Arnold Schwarzenegger and the Rise of Blockbuster Democracy* (Public Affairs, 2006), pp. 79-104.

**7** Despite the gutting, the state bumped up against the modified Gann limit at the peak of the dot-com boom. But no one knew it at the time and no tax rebates resulted.

**8** California, Commission on the 21st Century Economy, *Final Report*, September 2009. Available at http://www.cotce.ca.gov/documents/reports/documents/Commission_on_the_21st_Century_Economy-Final_Report.pdf

**9** “Swap Meet: Keeley Blows the Whistle on Parsky,” *Calbuzz*, December 19, 2009.

**10** Paul Krugman, “State of Paralysis,” *New York Times*, May 25, 2009.

**11** Quoted in Mark Leibovich, “Who Can Possibly Govern California?,” *New York Times Magazine*, July 5, 2009.

**12** Although it is sometimes argued that campaign spending against ballot measures is more effective than supportive spending, that view appears to be incorrect. However, in this case, opponents were able to outspend the governor. See John M. de Figueiredo, Chang Ho Ji, and Thad Kousser, “Financing Direct Democracy: Revisiting the Research on Campaign Spending and Citizen Initiatives,” working paper, June 8, 2010. Available at http://ssrn.com/abstract=1672408

**13** National Conference of State Legislatures, “State Budget Update: November 2009,” p. 56. The official starting date of the recession for the U.S. as a whole, determined by the National Bureau of Economic Research, was at the tail end of 2007.

**14** At this writing, the electoral fate of a proposition on the ballot in November 2010 (Prop 25) that would lower the budget threshold from two-thirds to a simple majority is unknown. However, were it to pass, the two-thirds requirement on tax increases (under Prop 13 of 1978) would remain in place.

**15** The sales tax increase was 1 cent effective April 1, 2009 ending June 30, 2011. Prior to the increase, the total state sales tax was 5 cents. (Local governments add their own sales taxes to the state tax which can double the total.) Each of the seven tax brackets in the personal income tax was raised by 0.25 percentage points for the 2009 and 2010 tax years. The car tax (Vehicle License Fee) was raised from 0.65 to 1.15 percent on May 1, 2009 and lasting until June 30, 2011. The car tax is a local tax collected by the state. When it was lowered under Gray Davis, the state reimbursed the local governments for the revenue loss. Davis tried to raise the car tax but his increase was reversed by Governor Schwarzenegger immediately after he took office after the recall. Raising the car tax rate decreases the money the state must pay the local governments.

**16** Assemblyman Anthony Adams was targeted by the John and Ken radio show in Los Angeles. After signatures for the recall were turned in, there turned out to be an insufficient proportion of valid

signatures. There was some suggestion that the signature-gathering firm had acted improperly but the issue died without a public airing of what happened. Adams was apparently induced to go along with the budget by a special law for his district that benefited a local redevelopment district. As it turned out, the law was invalidated by a court decision during the summer of 2010. See Dan Walters, "Anthony Adams' Shift on Tax Vote Backfires," *Sacramento Bee*, August 2, 2010.

**17** The incumbent Lieutenant Governor, John Garamendi, resigned after being elected to Congress in November 2009. Democrats were concerned that putting Maldonado into the Lieutenant Governorship might give him an incumbent's advantage in the election of November 2010. On the other hand, they thought they had a reasonable chance of replacing him with a Democrat in the senate once his seat was vacated.

**18** Campbell in some respects was more ideologically pure than his two rivals for the Republican nomination for governor. In the early 1970s, he supported liberal Democrat George McGovern for president but subsequently became a self-described Reagan Republican. In contrast, Meg Whitman gave money to various Democrats including US Senator Barbara Boxer in late 2003. Steve Poizner was a Gore supporter in the presidential campaign of 2000. Source: "Republicans for Democrats," Sacramento Bee, October 25, 2009.

**19** Housekeeper-gate unfolded shortly before Jerry Brown and Meg Whitman were due to debate on Spanish TV, placing the issue before a Latino voter audience. Whitman and her husband claimed that they did not know their employee was illegal because she gave them phony documentation. It appeared, however, that the Social Security administration notified them of a mismatch between the name of the employee and the Social Security number she gave. After denying knowledge of the letter, and then hinting that the housekeeper might have intercepted it, a copy of the letter surfaced with the handwriting of Whitman's husband on it. A hearing on the actual wage claim was scheduled, but for after the November election. Housekeeper-gate raised a portfolio of unpleasant issues: possibly hypocrisy on the immigration issue, mistreatment of an employee, and lifestyle issues such as an improbably large house, and husband with the unlikely name "Griff Harsh." Although not featured in the mainstream media, Internet reports of two Whitman overprivileged sons who behaved obnoxiously and possibly illegally were given added impetus by housekeeper-gate.

**20** Quoted in "Schwarzenegger to Leno: We'll Fix Budget," *San Diego Union-Tribune*, May 26, 2009.

**21** Quoted in a press release dated October 28, 2009 of Repair California, an organization associated with the Bay Area Council that pushed unsuccessfully for a state constitutional convention. The Bay Area Council is a business group which also includes some nonprofit organizations.

**22** Quoted in "Schwarzenegger for President? He Would If He Could," *Sacramento Bee*, April 29, 2010.

**23** Quoted in Peter Nicholas and Richard Simon, "Washington Declines to Help California, At Least for Now," *Los Angeles Times*, May 22, 2009.

**24** Joe Mathews, "Golden State Bailout," *Los Angeles Times*, May 22, 2009.

**25** The cuts appear in a table released by the governor's office entitled "All General Fund Solution Proposals for May Revision," May 29, 2009.

**26** Quoted in Neil Roland and Richard Truett, "U.S. Will Guarantee GM, Chrysler Warranties, Obama Says," *Automotive News*, March 31, 2009.

**27** It is difficult to find data on the total size of the muni bond market. A study of data in 2000 found the market to have about $2 trillion in outstanding securities. See U.S. Securities and Exchange Commission, "Report on Transactions in Municipal Securities," July 1, 2004, p. 5.

**28** Quoted in Kevin Yamamura, "Davis Sides with Ex-GOP Governors, Others on Line-Item Veto," *Capitol Alert*, October 7, 2009.

**29** At one point, proposed cuts in the pay of state-supported home care aides were challenged by the Obama administration as threatening federally mandated program requirements but that challenge was quickly dropped.

**30** "Furloughs and Budget Cuts Disrupting State Tax Collections," *California's Capitol*, February 12, 2010.

**31** Jon Ortiz and Phillip Reese, "Unused Vacation Time Could Wash Out State Furlough Savings," *Sacramento Bee*, March 11, 2010.

**32** "Text of Gov. Schwarzenegger's Speech to the Legislature," *Sacramento Bee*, June 2, 2009.

**33** Jerry Roberts and Phil Trounstine, "How May 19 Election is Just Like 'Rashomon,'" *Calbuzz.com*, June 3, 2009.

**34** The proposition provided for free admission to California cars on which the surcharge was paid.

**35** Joe Mathews, "Repair California Says There is a Blacklist," *Fox & Hounds*, February 4, 2010. Exactly why the signature firms would sabotage the process is unclear. There was some thought that perhaps they feared a constitutional convention would produce limits on their activities.

**36** Quoted in Jim Miller, "Inland Lawmaker Targets Secrecy of Big Five Budget Talks with Governor," *Riverside Press-Enterprise*, June 7, 2009.

**37** Quoted in Jerry Roberts and Phil Trounstine, "Friday Fishwrap: Sex, Gossip & Taxes," *Calbuzz.com*, June 12, 2009.

**38** Patrick McGreevy and Eric Bailey," Lawmaker Returns Joke Gift from Schwarzenegger," *Los Angeles Times*, June 18, 2009.

**39** Tim Gage, "How to Deal with California's Budget Problem," *California Journal of Politics & Policy*, vol. 1, issue 2, 2009. (Online journal.)

**40** Quoted in Jerry Roberts and Phil Trounstine, "Just In: Kennedy Whacks Davis, More on Gov Money," *Calbuzz.com*, July 2, 2009.

**41** Willie Brown, "State Should Have Seen Budget Mess Coming," *San Francisco Chronicle*, July 19, 2009.

**42** IOUs were about to be issued during the budget crisis of 1983 under Governor George Deukmejian. However, a bank loan was provided at the last moment and although the IOUs were technically issued, they were paid on demand as ordinary checks would have been.

**43** Quoted in "Promises, Promises," *Sacramento Bee AM Alert*, July 2, 2009.

**44** Presumably, those whose refunds were delayed did not owe such taxes, however.

**45** The U.S. Department of Labor expressed concern about the impact of furloughs on the processing of unemployment benefits—a federal/state joint program outside the General Fund.

**46** Arnold Schwarzenegger, "Gov. Arnold Schwarzenegger: Waste is Killing California," *Los Angeles Times* (op ed), July 3, 2009.

**47** The commercial may be seen as part of http://www.youtube.com/watch?v=UtOyw4Z-AG8 which also contains other commercials opposing the governor and other video from this period.

**48** Cuts ultimately made in the IHSS program triggered lawsuits which the Obama administration supported in a brief filed in early March 2010. The cuts were placed on hold by the court and a final decision had not been made at this writing.

**49** Henry S. Rowan, "A New York Solution for Bailing Out California," *Wall Street Journal*, July 8, 2009.

**50** Quoted in George Skelton, "Budget's a Mess, But It's Our Mess," *Los Angeles Times*, July 23, 2009.

51 Dan Walters, "Another Tricky Budget Devised for California," *Sacramento Bee*, July 21, 2009.

52 The furlough impact was partly offset by a two-month holiday from health insurance premiums.

53 As part of the budget deal, a vote was taken in the legislature on oil drilling off Santa Barbara. The proposal failed and the Assembly removed the vote from the official record to avoid embarrassing members who voted for the bill. Despite this failure and historical revision, the oil drilling proposal remained alive in subsequent gubernatorial budget proposals until the Gulf disaster when the governor abandoned the idea. While he did not abandon the idea of privatizing the state workers' comp fund, small business groups were opposed, fearing resultant hikes in workers' comp premiums.

54 The Legislative Counsel provided an opinion to Assembly Speaker Karen Bass on August 5, 2009 indicating that the line-item veto could not be applied to a budget revision. However, this opinion was just that—an opinion. The Schwarzenegger administration produced counter-opinions and the matter was ultimately decided in court. Apart from the lawsuit against the vetoes filed by Senate President Steinberg, a second lawsuit was filed by private advocacy groups for the disabled that were affected by the vetoes.

55 Apart from the income tax rate increase, there was a small unforeseen increase due to Consumer Price Index deflation. Tax brackets are indexed to the CPI and when there is deflation, the brackets are lowered proportionally. The CPI fell 1.5% from June 2008 to June 2009, leading to such bracket lowering for the 2009 tax year.

56 Quoted in "Schwarzenegger Responds to Steinberg's Suit Over Line-Item Vetoes," *Capitol Alert*, August 7, 2009.

57 Quoted in Susan Ferriss, "Steinberg to Sue Governor Over Vetoes," *Sacramento Bee*, August 8, 2009.

58 Marcia Fritz, president of Californians for Fiscal Responsibility, quoted in Jon Ortiz, "Schwarzenegger, Whitman Back Away from Ballot Measure to Cut Pension Costs," *Sacramento Bee*, February 24, 2010.

59 Quoted in Anthony York, "Big 5 Meeting Dissolves in Rancor," *Capitol Weekly*, October 6, 2009.

60 Quoted in Carla Marinucci, "You Lie!—Bad Manners or Just Politics," *San Francisco Chronicle*, October 9, 2009.

61 The veto message read: *For some time now I have lamented the fact that major issues are overlooked while many unnecessary bills come to me for consideration. Water reform, prison reform, and health care are major issues my administration brings to the table but the legislature just kicks the can down the alley. Yet another year has come and gone without the major reforms Californians overwhelmingly deserve. In light of this, and after careful consideration, I believe it is unnecessary to sign this measure at this time. Sincerely, Arnold Schwarzenegger.* (A year later, apparently all was forgiven and the governor signed a bill by the same author with a more pleasant hidden message: You are welcome.)

62 The governor was instrumental in creating a "California Latino Water Coalition"—seen by some as an "Astroturf" group rather than a grass roots entity—to push his water agenda. The internal politics of the water bond are described in Steve Wiegand, "Water Package: Sealing the Deal," *Sacramento Bee*, November 29, 2009. Much of the public controversy at the time and after the deal was over the degree of "pork" in the bond agreement. Less prominent was the issue of additional general obligation debt to fund infrastructure, a practice that had apparently become ensconced after the 2006 infrastructure program the governor had sponsored.

63 The quote appears in the last line of a letter from Brown to State Senator Jeff Denham and Assembly majority leader Alberto Torrico dated October 9, 2009.

64 After Columbus Day passed, the union and administrative officials had predictably different versions of the degree to which workers stayed home.

65 The suit was filed later and is pending at this writing.

66 Despite the park cutbacks, Governor Schwarzenegger received an award—which sparked controversy given the cuts—from the National Park Trust on October 29, 2009.

**67** During 2006-07, 31% of California children under age 18 were covered by Medi-Cal. The figure was 72% for those in families under the federal poverty level. Source: California HealthCare Foundation, *California Health Care Almanac*, November 2009.

**68** California Field Poll of October 14, 2009 at http://field.com/fieldpollonline/subscribers/Rls2316.pdf.

**69** Quoted in "Modesto Native Lucas Among 13 Added to California Hall of Fame," *Modesto Bee*, December 3, 2009.

**70** The quote is from gubernatorial advisor Adam Mendelsohn and appears in Carla Marinucci, "Governor Looking at Part-Time Legislature," *San Francisco Chronicle*, August 20, 2009. California had a part-time legislature until reforms were enacted in the mid-1960s.

**71** John Myers, "Brown, Whitman Lukewarm on Reform," KQED Capital Notes, October 20, 2010; David Siders, "Whitman Willing to Take Pension Cutbacks to the Ballot Box," *Sacramento Bee*, September 21, 2010.

**72** UC president Mark Yudof pledged to raise financial aid money to offset the tuition increases for needy students. Students whose families had incomes below $70,000 were also promised some protections from the increase.

**73** Prop 14 was put on the ballot by the legislature to get the vote of Republican state senator Abel Maldonado. Maldonado came from a "swing" district and thought such a reform would help politicians like him. He was later rewarded with an appointment as Lieutenant Governor by Governor Schwarzenegger.

**74** With all candidates running in a single primary, it is very unlikely that a minor party candidate would be among the top two candidates that would be on the ballot in the general election. Of course, minor party candidates could participate in the primary.

**75** Quoted in Martin Wisckol, "Jerry Brown Shows O.C. his Moderate, Populist Side," *Total Buzz Blog, Orange County Register*, October 30, 2009.

**76** Quoted in George Skelton, "Poizner Sticks to the Supply Side," *Los Angeles Times*, November 2, 2009.

**77** Legislative Analyst's Office, "The Master Plan at 50: Assessing California's Vision for Higher Education," November 12, 2009.

**78** Luciana Dar, "The Political Dynamics of Higher Education Spending," Graduate School of Education, UC-Riverside, August 2009, unpublished working paper.

**79** Public Policy Institute of California, "Californians & Higher Education," November 2009.

**80** Hans Johnson and Ria Sengupta, "Closing the Gap: Meeting California's Needs for College Graduates," Public Policy Institute of California, April 2009.

**81** "USC/Los Angeles Times Poll: California Statewide Survey Results," *Los Angeles Times*, November 6, 2009.

**82** Quoted in Shane Goldmacher, "Schwarzenegger's Budget Boss to Step Down," *Los Angeles Times*, November 3, 2009.

**83** Quoted in Sarah Murray, "State Finance Directors Warn of More Trouble Ahead," *California Weekly*, November 13, 2009.

**84** Dan Walters, "State Budget, Genest Both Underwater," Capitol Alert, *Sacramento Bee*, January 14, 2010.

**85** US Senate Dianne Feinstein was sometimes mentioned as a gubernatorial candidate, although she eventually excluded herself in February 2010.

**86** The group that filed the initiatives was the California Foundation for Fiscal Responsibility, a group sponsored by various taxpayer organizations and associated with such figures as John Moorlach, an Orange County Supervisor, Keith Richman, a former assemblyman from Northridge (now deceased), and Ted Costa of People's Advocate, the organization that kicked off the recall of Governor Gray Davis in 2003.

**87** Dan Regan, "Going Green Puts Recyclers in the Red," *Capitol Weekly*, March 11, 2010. A report of the Legislative Analyst noted that loans from the Beverage Container Recycling Fund were squeezing the program. It suggested leaving major changes in the program until after the May revise. See Legislative Analyst's Office, *The 2010-11 Budget: Funding and Policy Options for the Beverage Container Recycling Program*, March 18, 2010.

**88** Quoted in Judy Lin, "Schwarzenegger: No Fire Sales of Calif. Buildings," *San Jose Mercury News*, April 21, 2010.

**89** Later, a complicated financial arrangement involving a public agency was proposed for such a sale. (Little was said about the arrangement in public. A legal notice of it appeared in the print edition of the Los Angeles Times, May 27, 2010, p. B8.) The scheme was described as a "lease lease-back" in which a public authority would sell bonds to lease—not buy—the buildings and then lease the property back to the state. In effect, it was a complicated borrowing plan. See Daniel Miller, "State Finding It Hard to Let Go," *Los Angeles Business Journal*, June 28, 2010. That plan was apparently discarded and at this writing buyers for the buildings have been announced but the deal had not been completed. The governor was reported to have removed appointees to various bodies that oversee state property, appointees who apparently were opposed to such sales. An attempt to sell the Orange County Fairgrounds fell through in March 2010 when bids were judged to be too low. However, the state made a deal in October 2010 to sell the property while opponents threatened to block the arrangement. On the problems entailed in selling assets and leasing them back, see Christopher Thornberg, "A Bad Deal: An Analysis of the Pending California State Official Building Sale/ Leaseback Program," Beacon Economics, April 9, 2010. The SEIU—representing state workers who might be displaced by the sales—financed the report, but its conclusions were not disputed by fiscal experts. See Legislative Analyst's Office, *Evaluating the Sale-Leaseback Proposal: Should the State Sell Its Office Buildings?*, April 27, 2010. The LAO urged the legislature to find other alternatives.

**90** At this writing, it appears the decision by federal authorities will be challenged in court.

**91** Steven Clifford, "University of California at Berkeley to Eliminate All Students on Jan. 1," *Huffington Post*, December 18, 2009. The mock article also pointed out that by admitting no one, Berkeley would become the most selective university in the US News rankings.

**92** The reduction could in theory be accomplished by admitting fewer prisoners into state prisons (presumably by keeping them in local jails) or sending more prisoners to out-of-state or private prisons. About 150,000 prisoners were kept in state facilities at the time of the order.

**93** The position became vacant when Lieutenant Governor John Garamendi won a seat in Congress in a special election

**94** Office of the Governor, press release dated December 22, 2009.

**95** "Transcript of Gov. Arnold Schwarzenegger Delivering State of the State Address," *Sacramento Bee*, January 6. 2010.

**96** Quoted in Robert Cruickshank, "Jerry Brown is Trapped in 1978," *Calitics.com*, January 6. 2010.

**97** Quoted in "What They're Saying About the State of the State," Political Blotter, *Sacramento Bee*, January 8, 2010.

**98** Public sector union officials declined to attend or support Willie Brown's annual breakfast in October 2010 because of his pension stance. However, Governor Schwarzenegger did attend.

**99** Kevin O'Leary, "California Deficit: Arnold Has to Make a 'Sophie's Choice,'" *Time*, January 9, 2010. Information in this article about the governor's legacy preference was attributed to his "aides."

**100** Although not part of the General Fund, California unemployment insurance claims rose dramatically in the Grate Recession. As a result, the state's unemployment benefit fund showed a negative and worsening balance beginning in calendar 2009. In such situations, the federal government loans states sufficient funds to keep the program operating. And certain dispensations were given as part of the Obama stimulus plan. However, the state will eventually have to raise taxes on employers and pay interest on its debt to the federal government.

**101** "Start from Scratch on Health Care? 'Bogus Talk,'" Says Schwarzenegger, *Capitol Alert*, February 22, 2010.

**102** Quoted in Cathy Bussewitz, "Calif. Takes Steps to Cover Medically Uninsured," *San Jose Mercury-News*, June 27, 2010.

**103** "Arnold Schwarzenegger: Obama will win in 2012," *Politico*, October 5, 2012.

**104** Some information about the amendment was included in a press release of the Office of the Governor dated January 6, 2010. A formula, according to the release, would require that in 2014-15, 10% of "taxpayer money" would go to higher education and no more than 7% to prisons. Specific wording of the proposed amendment was not included.

**105** Legislative Analyst, *Prisons vs. Universities Proposal Would Unwisely Lock Up Budget Flexibility*, January 26, 2010.

**106** Quoted in Kevin Yamamura, "Don't Count on Windfall from U.S., California Legislative Analyst Says," *Sacramento Bee*, January 13, 2010.

**107** Quoted in Dan Walters, "Schwarzenegger Reverts to Fantasy with Budget Proposal," *Sacramento Bee*, January 10, 2010.

**108** Quoted in Michael Rothfield and Richard Simon, "Washington Fires Back at Schwarzenegger," *Los Angeles Times*, January 15, 2010.

**109** Quoted in Timothy Egan, "Arnold's Last Yodel," Opinionator Blog, *New York Times*, January 13, 2010.

**110** Joe Mathews, "The Crazy Glue Governor, and the Real Shame of California," online commentary, New America Foundation, January 25, 2010.

**111** Josh Richman, "Bill Lockyer: Arnold Right to Veto Gas-Tax Swap," Political Blotter, *Contra Costa Times*, March 17, 2010.

**112** Kevin Yamamura, "2009 Legislative Leaders Win JFK Profile in Courage Award," *Capitol Alert*, March 16, 2010.

**113** Spokesperson Aaron McLear quoted in Steven Harmon, "Governor Schwarzenegger Talking Through his Sombrero Again, Aide Says," *Contra Costa Times*, January 26, 2010.

**114** Quoted in Larry Gordon, "UC Regents Not Eager to Take on California's Prison Healthcare," *Los Angeles Times*, March 26, 2010.

**115** Campbell had originally been in the gubernatorial race but switched to the senate race when polls indicated he was not doing well against Meg Whitman and Steve Poizner.

**116** Duane W. Gang, "Fiorina: State Should Keep Bankruptcy as Option," *Riverside Press-Enterprise*, February 9, 2010.

**117** Andrew S. Ross, "Bottom Line," *San Francisco Chronicle*, March 11, 2010.

**118** Carla Marinucci, "Will Jerry Brown's 1992 Signature Issue, Flat Tax, Rise Again in 2010?," The Spin Cycle blog, *San Francisco Chronicle*, February 12, 2010. Spokesperson Steve Glazer said Brown had favored the flat tax at the federal level. But when asked if Brown was against the flat tax for the state, Glazer replied "He's not saying that."

**119** Quoted in press release from the Brown campaign dated March 2, 2010.

**120** Opponents to Whitman tended to cite her Wall Street rather than "business" ties. There were counter-attempts by Whitman and allies to try and link Brown to Wall Street in some way. It was claimed that while Brown was mayor of Oakland, the City made what turned out to be a disadvantageous interest rate swap with Goldman Sachs. Also raised were questions about Brown family ties—particularly Jerry Brown's father (and former governor) Pat Brown—as consultants to the Indonesian dictatorship in the 1970s. As noted in an earlier footnote, with regard to family, media reports appeared of loutish behavior by Whitman's sons in prep schools and university. Poizner's attempt to sell himself as an education reformer was somewhat undermined by a "This American Life" broadcast in late April 2010 that questioned the premise of a book he had written about his attempt to aid what he depicted as a gang-infested school. There were also questions about whether the book had been artificially boosted by campaign-related purchases aimed at making it a "best seller."

**121** Quoted in Steve Harmon, "Brown, Holding Forth," Politics Blotter blog, *Contra Costa Times*, April 16, 2010.

**122** Legislative Analyst's Office, *The 2010-11 Budget: Resources and Environmental Protection*, March 8, 2010.

**123** Legislative Analyst's Office, *The 2010-11 Budget: Transportation*, March 2, 2010.

**124** Legislative Analyst's Office, *The 2010-11 Budget: Higher Education*, February 25, 2010.

**125** Legislative Analyst's Office, *The 2010-11 Budget: Proposition 98 and K-12 Education*, February 25, 2010.

**126** Legislative Analyst's Office, *Year-One Survey: Update on School District Finance and Flexibility*, May 4, 2010.

**127** Legislative Analyst's Office, *The 2010-11 Budget: Health & Social Services—A Restricted Environment*, March 2010; Legislative Analyst's Office, *The 2010-11 Budget: Health and Social Services Budget Primer*, March 2010

**128** There was some evidence of a spike in retirements, perhaps a symptom of workers close to retirement age deciding that the climate of public employment was not favorable. See Jon Ortiz, "California State Worker Retirements Spike," *Sacramento Bee*, April 14, 2010.

**129** See Public Policy Institute of California, *Californians & Education*, April 2010.

**130** See Bay Area Council, *Recession and Recovery: An Economic Reset*, April 2010.

**131** Memo from Legislative Analyst Mac Taylor to Legislative Budget Staff dated March 19, 2010 and entitled "March 2010 Fiscal Update."

**132** Public Policy Institute of California, "Californian & the Environment," July 2010.

**133** Press release from the governor's office, May 14, 2010.

**134** Press release from Senator Steinberg's office, May 14, 2010.

**135** Quoted in Patt Morrison, "Willie Brown: State's Man," *Los Angeles Times*, August 21, 2010.

**136** Anthony York, "Whitman Says Schwarzenegger Welfare Cut Goes Too Far," Political Blog, *Los Angeles Times*, May 17, 2010. GOP candidate Steve Poizner also said a complete elimination of CalWorks went too far and noted the loss of federal matching dollars such an elimination would entail.

**137** "Schwarzenegger Unveils Stark Budget Plan: Democrats Balk," *California's Capitol*, May 14, 2010.

**138** Robles-Wong v. California was filed in Alameda Superior Court on May 20, 2010.

**139** Press release from the governor's office, July 8, 2010.

**140** Arnold Schwarzenegger, "Public Pensions and Our Fiscal Future," *Wall Street Journal*, August 27, 2010.

**141** Quoted in John Myers, "Budget +55: 'Robbed Blind,'" *KQED Capitol Notes*, August 24, 2010.

**142** The proposal as leaked was unclear. It reportedly involved borrowing against the saving from future pension reform. Borrowing from a pension fund would involve paying interest at a rate higher than the usual tax-exempt municipal bond. Such tax exemption is worthless to pension funds since they don't pay taxes and, hence, do not normally invest in tax-exempt bonds. The state would have to pay interest to CalPERS in any borrowing competitive with taxable securities carrying equivalent risk.

**143** Quoted in John Myers, "Budget +26: Kinder, Gentler PR," *KQED Capitol Notes*, July 26, 2010.

**144** Quoted in Anthony York, "Pérez Finds an Open Budget Process is Easier Said Than Done," Political blog, *Los Angeles Times*, July 15, 2010.

**145** Quoted in Anthony York, "Pérez Finds an Open Budget Process is Easier Said Than Done," Political blog, *Los Angeles Times*, July 15, 2010.

**146** There were some court decisions on matters relating to the minimum wage issue in late August but the technical and legal feasibility issue remained in abeyance.

**147** Quoted in "Brown Says State Government Has Become 'Constipated,'" PolitiCal blog, *Los Angeles Times*, July 1, 2010.

**148** Quoted in David Siders, "Schwarzenegger Jabs at Whitman," *Capitol Alert*, June 28, 2010.

**149** Shane Goldmacher, "Schwarzenegger Says He Would Not Have Been Able to Win a Republican Primary," PolitiCal blog, *Los Angeles Times*, June 11, 2010.

**150** Quoted in "Jerry Gets Cosmic, Meg Prez Fever Grows," *Calbuzz*, June 12, 2010.

**151** Quoted in Peter Hecht, "Brown Vows 'Agenda of Humility' in Primary Night Victory Speech," *Capitol Alert*, June 8, 2010.

**152** Quoted in Jack Chang, "Jerry Brown: Start Budget Process Before January," *Capitol Alert*, June 10, 2010.

**153** Quoted in David Siders, "Tom McClintock Still 'Not Prepared to Endorse' Meg Whitman," *Capitol Alert*, August 6, 2010. In October, McClintock stated, "I agree with (Whitman) maybe 20 percent of the time. I agree with Jerry Brown about 20 percent of the time. I agree with the libertarians about 80 percent of the time. So I'm not making an endorsement…" Quoted in Brian Leubitz, "Tom McClintock Still Doesn't Like eMeg, Part 2," *Calitics*, October 19, 2010.

**154** UC and CSU fronted the funds for students who otherwise would have received Cal Grants on time. But community college districts were not able to do so.

**155** In mid-August, the controller suggested that IOUs would be issued in September but a later clarification pushed the date to October.

**156** Carl E. Klarner, Justin H. Phillips, and Matt Muckler, "The Causes of Fiscal Stalemate," unpublished working paper date August 17, 2010, http://ssrn.com/abstract=1660494.

**157** Quote from "Gov. Schwarzenegger Holds Press Conference to Discuss the Budget," posted September 1, 2010 at http://www.gov.ca.gov/speech/15909/.

**158** Quoted in Shane Goldmacher, "2 California Propositions Could Undo Budget Patch," *Los Angeles Times*, August 4, 2010.

**159** There is cross-state evidence that legislators that produce late budgets are penalized by voters. However, California's gerrymandered election districts that keep incumbents safe may mute this effect. See Asger Lau Andersen, David Dreyer Lassen, and Lasse Holbøll Westh Neilsen, "Fiscal Governance and Electoral Accountability: Evidence from Late Budgets," working paper, August 27, 2010, University of Copenhagen.

**160** Dan Walters, "Legislators Add to Woes with San Diego Arena Deal," *Sacramento Bee*, October 20, 2010.

**161** Moody's Investors Service, *California Budget Likely to Lead to Mid-Year Shortfall and Large Gaps in Future Years*, October 18, 2010.

**162** George Skelton, "Privies Pinched Without Budget Deal," *Los Angeles Times*, September 23, 2010; Gary Richards, "Lack of Budget Means $3.9 Billion in Transportation Funds on Hold," *San Jose Mercury News*, September 23, 2010.

**163** Under final offer arbitration—sometimes called "baseball" arbitration because of its use in team vs. player salary disputes—an arbitrator must pick the proposal of one side or the other and cannot compromise or split the difference. "Brown Proposes Baseball Arbitration Budget Plan," *Calbuzz*, September 20, 2010.

**164** Zero-based budgeting as an abstraction is appealing. But many programs are assumed to be ongoing—such as social welfare programs, schools, and higher education. They cannot as a practical matter start from zero each year. Jack Chang, "Jerry Brown Unveils Start-from-Scratch Budget Plan for California," *Sacramento Bee*, September 16, 2010.

**165** One bill would have authorized advertising on freeway electronic signs. Another would have allowed slant drilling for oil in certain areas (drilling from land to undersea deposits). Exactly what understanding there might have been is, of course, impossible to determine. See Anthony York, “Behind the Scenes: The Fight Over Freeway Advertising,” *Capitol Weekly*, October 14, 2010.

**166** The official line was that since the buildings would be leased for twenty years by the state, all calculations of the cost should end there—which showed leasing and ownership would cost the same. The problem is that at the end of the period, the state has no office building. It must at that point either lease, buy, or build to obtain space.

**167** A medical parole bill was signed by the governor in September 2010 which covered incapacitated inmates. However, the annual saving projected for this bill was very small compared to the cut in prison spending in the budget.

**168** Quoted at the annual Willie Brown breakfast in David Siders, “Schwarzenegger Leaves Criticism of GOP Lawmakers Behind, Praises Compromise on Budget,” *Capitol Alert*, October 19, 2010.

**169** Quoted in Jack Chang, “Jerry Brown Admits Past Errors, Vows Not to Repeat Them if Elected Again,” *Sacramento Bee*, September 12, 2010.

2

# OF DOLPHINS, CONDORS, AND SNAPPING TURTLES:

## THE 2011 CALIFORNIA POLITICAL FORECAST

**BILL PARENT**

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# 2

The principal reason that California is ungovernable is that both halves of its voting population believe that the other half is comprised of Martians. To sit at a bar in San Francisco and a bar in Barstow is to sip with patrons from different planets. A mosque, a gay marriage, a penny increase in a sales tax, or a delta smelt are viewed as if from opposite ends of a telescope. It's like the difference between dolphins and condors.

## DOLPHINS AND CONDORS

The dolphins live along the coast, particularly in the areas of San Francisco and Los Angeles. Often descendants of New Deal-New Frontier dolphins, they tend to favor a more active government and increased spending on education, environmental protection and health care. Dolphins are wary of private, corporate power. They support ballot measures that increase protections for minorities and they see a strong government role in assisting the poor. The more Reaganite condors, who tend to live more inland and south, perch, often passionately, on the opposite side on all of those issues.

On immigration, for instance, just over 60 percent of dolphins see immigrants as "a benefit" to the state, while over half of the Condors see immigrants as "a burden."[1] In the past decade, the dolphins voted against the recall of former Governor Gray Davis and in favor of affirmative action. They also voted in favor of a loosening of the constitutional requirement requiring a two-thirds majority to pass a budget or a budget-related tax increase.  But inland, the condors punched the other box on each of those issues.

The condors believe strongly in smaller, limited government, less regulation, tax cuts--both to lessen the burden and to stimulate growth—and, often, an absolute right to bear arms. According to a recent

Public Policy Institute of California (PPIC) survey, 70 percent of California dolphins said they are willing to pay higher taxes for a state government that provides more services. But the same 70 percent of condors preferred lower taxes and fewer services.[2]

There are more dolphins than condors, but the condors are a more resolute bunch than the dolphins. In a *Los Angeles Times* exit poll after the 2008 election, two out every three California condors described themselves as conservative. In contrast, just over half of the dolphins described themselves as liberal, and a third saw themselves as moderates. Only 22 percent of the voters overall identified themselves as liberal, while 34 percent identified themselves as conservative, and 44 percent identified themselves as moderate.[3] It's also the difference, as columnist and author Peter Schrag sees it, between "older, whiter, more affluent people who vote and the younger, browner, poorer people who are most dependent on the schools and other public services."[4]

## DOLPHIN-CONDOR CASE IN POINT: SAME SEX MARRIAGE

The difference between the dolphins and condors has been most starkly illustrated in the case of same sex marriage, where the dolphins and condors have voted as mirror images of the other.[5] In 2008, Proposition 8 called for a state constitutional amendment eliminating the right of same-sex couples to marry. Over 70 percent of the voters in 13 of California's more condor counties, north and south, voted in favor of Proposition 8 (Modoc, Shasta, Lassen, Tehama, Glenn, Sutter, Colusa, Calaveras, Merced, Tulare, Kings, Kern, and Imperial). The dolphins along the northern and central coast opposed the measure by almost the same margin. "Yes" on Proposition 8 passed statewide by a 52-48% margin. (In Los Angeles County, "yes" votes barely edged out "no" votes, setting off a bitter and acrimonious aftermath).

The vote on same sex marriage also illustrates that the divide is more complicated than simple political partisanship. There is also a big middle. Just prior to the November 2010 election, 44 percent of California's voters were registered as Democrats. Thirty-one percent were Republicans. Twenty percent were nonpartisan, "decline to state" voters. The remaining five percent were registered with minor parties.[6]

Sometimes, as in the case of Proposition 8, the "decline to state" voters tend to go with the condors. In the 2008 election of Barack Obama, however, following a national trend, they voted with the dolphins. But in the 2010 mid-terms elections they, unlike the rest of the country, stayed with the dolphins. For these 20%, we need a new classification, something amphibious, with a knack for camouflage and a strong bite; let's call them the snapping turtles.

## WALRUSES, COYOTES, AND MORE

There are other, smaller subgroups, of course, such as walruses, found in places like the Silicon Valley. Walruses are socially dolphins. But having become wealthy and less reliant on public services such as schools and subsidized health care, they tend to vote with the condors.

There are also coyotes, libertarian mongrels who claim everything from objectivist Ayn Rand to eco-poet Gary Snyder as their political parents. Not to be confused with independent-minded snapping turtles, the coyotes put a high value on their self-sufficiency and have a disdain for government. Anarchists at heart, coyotes are sometimes seen at Tea Parties, but

the primary Tea Party audience mainly consists of a particularly rabid group of condors.

However, most condors, in fact, don't attend Tea Parties. They are more often found in evangelical churches. These saddleback condors, we'll call them, usually deliver solidly for Republican candidates and anti-tax measures. But of late, the younger saddlebacks have shown themselves to be more like dolphins on such social issues as gay marriage and abortion.[7]

California's Latinos, who comprise over 37% of the state's adult population, but only 16% of its likely voters, in many ways think like condors on social issues. But they tend to vote with the dolphins on economic issues, a stance solidified because the condors have a recent record of not being very welcoming to them. California's Asian Americans, who comprise 12-13% of the population and 8% of likely voters lean slightly toward the condors. California African Americans, who comprise 6% of the population and 5% of likely voters, are almost always dolphins. But they are sometimes advised otherwise from the pulpits of their churches—as occurred in the case of Proposition 8.[8]

## DOLPHINS, CONDORS, SNAPPING TURTLES AND THE 2010 JUNE PRIMARY

In early 2010, things looked good for the condors in California. Across the country in liberal Massachusetts, Republican Scott Brown was elected to the U.S. Senate, defeating the Democratic candidate anointed to replace the late Senator Edward M. Kennedy. His election delivered a rebuke to the Obama Democratic sweep two years before. In addition, the Supreme Court had ruled 5-4 in the *Citizens United* case that government may not ban political spending by corporations and unions, a decision seen as a net potential boon for Republican candidates.

Early polling showed Democratic candidates Senator Barbara Boxer and Attorney General Jerry Brown—running for governor—to be vulnerable. A December 2009 PPIC poll showed that 61% of Republican respondents believed that "experience in running a business" was the most important quality they would seek in a candidate.[9] That view also resonated initially with Latino voters. Three of the statewide Republican candidates—Carly Fiorina for Senate, Insurance Commissioner Steve Poizner, and Meg Whitman for Governor—had such suitable high-tech business backgrounds and substantial personal wealth on which to draw.

Whitman told supporters she was willing to spend $150 million of her own fortune. That sum was an almost incomprehensible figure in state political history (but in the end she came close to spending it). A fourth candidate, Tom Campbell, a former congressman, state legislator, state finance director, law professor, and UC-Berkeley business school dean, lagged behind the front-runners in cash and name recognition from the beginning. Campbell initially entered the gubernatorial race but then switched to the senate contest.

In the primary campaign, on the Democratic side, Brown and Boxer ran pretty much unopposed. On the Republican side, however, where there were multiple candidates, there was heated battle not to be outflanked on the right, particularly on immigration. The GOP base was also energized by a new Arizona law allowing police to question people suspected of illegal residency. Whitman and Poizner engaged in ad wars and debates trying to out tough the other on immigration penalties and deportation.

The immigration issue has been a conundrum for candidates appealing to condors; to win the primary they have to show their white-Anglo base toughness against a group within the Latino population. Few Latinos are registered as Republicans so they have little impact on the GOP primary. But they comprise a significant share of the votes in the general elections, including 2010.[10]

The Republicans spent record amounts of money on the primary campaign. Whitman spent almost $70 million of her own money, Poizner $25 million, and Fiorina $7 million. By way of comparison, the total cost of Whitman's primary campaign, $81 million, was equal to what *both* sides spent on the record-breaking Proposition 8 campaign two years before. In the end, Whitman and Fiorina prevailed on the Republican side. That outcome set up a classic condor-dolphin confrontation between pro-business Republican "outsiders" and career Democratic office holders; the liberal Barbara Boxer for Senate and the enigmatic state attorney general, former governor, and Oakland mayor, Jerry Brown.

## DOLPHINS, CONDORS AND THE PRIMARY BALLOT QUESTIONS

In addition to clear cut choices for elected office, on the state primary ballot was a collection of propositions, which also illustrated the dolphin-condor divide. The dolphin-condor divide was clearest on two unsuccessful corporate-sponsored measures, Proposition 16, which would have required a two-thirds majority to establish or expand public electricity providers, and Proposition 17, which would have allowed auto insurance companies to charge based on continuity of insurance coverage. Predictably, the eastern condor counties tended to vote yes to give private businesses sway over government regulation; the coastal dolphins voted the other way.

Proposition 15, an experimental, test-the-waters measure to establish a public campaign finance system just for Secretary of State elections, was roundly defeated, carrying only the most liberal Bay Area counties. Notably, this proposition came along in an election cycle where a record amount of personal and private money was being spent, and dolphin outrage over *Citizens United* decision was palpable. The defeat of Prop 15 was devastating for advocates of campaign finance reform to level the playing field, and a major a victory for those opposed to public spending on political campaigns.

Proposition 13, a legislatively-referred constitutional amendment prohibiting the reassessment of property values due to seismic retrofitting work, was the biggest winner of the day. It garnered over 80% of the vote. The total may well have reflected the fact that the anti-property tax hike sentiment that spurred 1978's Proposition 13 is still very much alive in California.

## PROPOSITION 14: A POSSIBLE POLITICAL GAME-CHANGER

Also on the ballot was a potentially divide-challenging measure to institute open primary elections in California. Proposition 14 passed 53.7% to 46.2%. It carried all but two condor counties, Tulare and Orange. The dolphin-condor divide was blurred and the snapping turtles were not a deciding factor. That outcome suggested that one thing on which condors, dolphins, and snapping turtles can agree is that giving themselves more power and choice in the political system is a good thing.

How much of the support or opposition was related to the intent of the measure, which was to produce more moderate legislators, is unclear. A look at the supporters and opponents reveals an odd set of interests and alliances. The measure was strongly supported by Governor Arnold Schwarzenegger and by such groups as the Latino Business Association and the bi-partisan political reform group California Forward. It was opposed by gubernatorial candidate Meg Whitman, Ralph Nader, and the League of Conservation voters.

What is clear is that unless Prop 14 is blocked by litigation, starting in 2012, primary voters will be handed one ballot with all of the candidates listed. The top two vote-getters, regardless of party, will advance to the general election run-off. As George Skelton explained in the *Los Angeles Times*:

> *"In a heavily Democratic legislative district, it's possible that the runoff could pit two Democrats against each other—one a liberal, the other more moderate. Ditto a district dominated by GOP voters—a conservative against a centrist. It's not inconceivable that a Green Party candidate could wind up in a San Francisco runoff, or a Libertarian in an Orange County general election . . . The goal is to force candidates to appeal to a wider range of voters than they currently do in party primaries dominated by ideologues. The idea is to elect more pragmatic moderates, especially to the frequently gridlocked Legislature."*[11]

Nonpartisan elections are common in California local government, but the only statewide blanket primary is in Louisiana. There, it is known as the "jungle primary" because of its unpredictability in a large field of candidates. It opens the potential for tactical voting across party lines, e.g. voting for the weakest candidate of the opposite party. One could imagine, for instance, Democratic Latino voters choosing to eliminate the most anti-immigration Republican candidate in the primary, thereby giving Latinos a choice among moderates in the general election. Mischief is also possible, as in Louisiana, for instance, when white supremacist David Duke once made his way into the governor's race with just 33 percent of the primary vote.

## DOLPHINS, CONDORS, SNAPPING TURTLES AND THE GENERAL ELECTION

In terms of Californian's political divides, the 2010 general election for Governor and U.S. Senator were textbook illustrations of the dolphin-condor divide. The Snapping Turtles, who voted strongly for Arnold Schwarzenegger in the last gubernatorial election, shifted their support to Jerry Brown and Barbara Boxer. In the end, Brown got 53.7% of the vote and Whitman got 41.2%; Boxer, 52.1% and Fiorina 42.5%. Latinos, turned off by the anti-immigration fervor of the primary and the revelation of the firing of Whitman's long-time undocumented housekeeper, swam strong with the dolphins. In California's gubernatorial race, Democrat Jerry Brown won 64% of California's Latino vote while Republican Meg Whitman won 30%.[12]

As it turned out, the most interesting aspect of the election was California's independence from national trends. Elsewhere, incumbents were tossed and Republicans swept to control of Congress. Also, outside California, Republicans gained a record number of state legislative and governorships.

## BALLOT QUESTIONS IN THE GENERAL ELECTION: CRACKS IN THE DIVIDE?

In terms of the dolphin-condor divide, however, it is interesting to look at the inconsistencies across the state the ballot questions. While Proposition 19, which would have legalized, regulated, and taxed marijuana, was roundly defeated 54% to 46%, it passed in only twelve counties, and was strongly opposed in eastern California. Prop 19 even failed by the statewide average of 54% to 46% in Humboldt County, where it is estimated to be the largest agricultural product in the region. Exit polls showed the differences were more defined by age than geography, with a majority of 18- to 39-year-olds voting in favor and those over 40 voting against.[13]

The majority of dolphins, condors, and snapping turtles did agree when it came to voting against any tax and fee increases. Proposition 23, which would have levied an $18 fee on car registration to go toward state parks, was defeated 57% to 43%. Its only support come from the heart of dolphin country, the stretch of coast from Monterey to Sonoma, plus Yolo County, where the rare, inland, dolphin city of Davis is located.

Proposition 22—which prohibited the state legislature from taking local monies earmarked for transportation and construction and re-allocating it to support the general fund—was strongly supported, 61% to 39%. Marin and San Francisco, however, voted against Prop 22. By a similar margin on Proposition 24, voters also refused to repeal a series of tax breaks for business recently enacted by the legislature. Had the repeal gone through, Prop 24 would have raised an additional $1.3 billion in tax revenue. Marin and San Francisco voted in favor of the repeal.

A sign of the softening of the divide came in the passage of Proposition 25, which gives the legislature the ability to pass a budget with a majority vote instead of the two-thirds vote previously required. The measure also docks legislators' pay for late budgets. While a two-thirds majority is still necessary to raise taxes and fees (see next paragraph), the new rule makes it easier to pass a budget. The measure passed 55% to 45% with the condors holding out in the north- and southeast corners of the state.

But in the divide hardened again, however, on Proposition 26, which will require the legislature to garner two-thirds majority, as it does for tax increases, for fee increases. The measure, which passed 52%-47%, was opposed along the dolphin coast, joined by Los Angeles and Santa Barbara Counties. Many condors and snapping turtles viewed fee increases as a legislative trick to get round the two-thirds vote of both legislative houses needed for a tax increase. The legislature had included about $1 billion in such fee increases in the 2010-11 state budget. Prop 26's provisions also apply to fees imposed on private companies to pay for environmental measures related to their processes and products, which was a key argument against the initiative.

Although inconsistent with their vote on Proposition 26, dolphins, condors, and snapping turtles were very strong in their opposition to Proposition 23. Prop 23 would have suspended implementation of California's landmark emissions standards passed by the legislature as AB 32. Support for the measure was largely concentrated in the northeastern corner of the state where unemployment is highest and the air is cleanest. Even Republican Orange County supported the measure by a narrow 50.5% to 49.5% margin.

# REDISTRICTING: A SLIVER OF HOPE

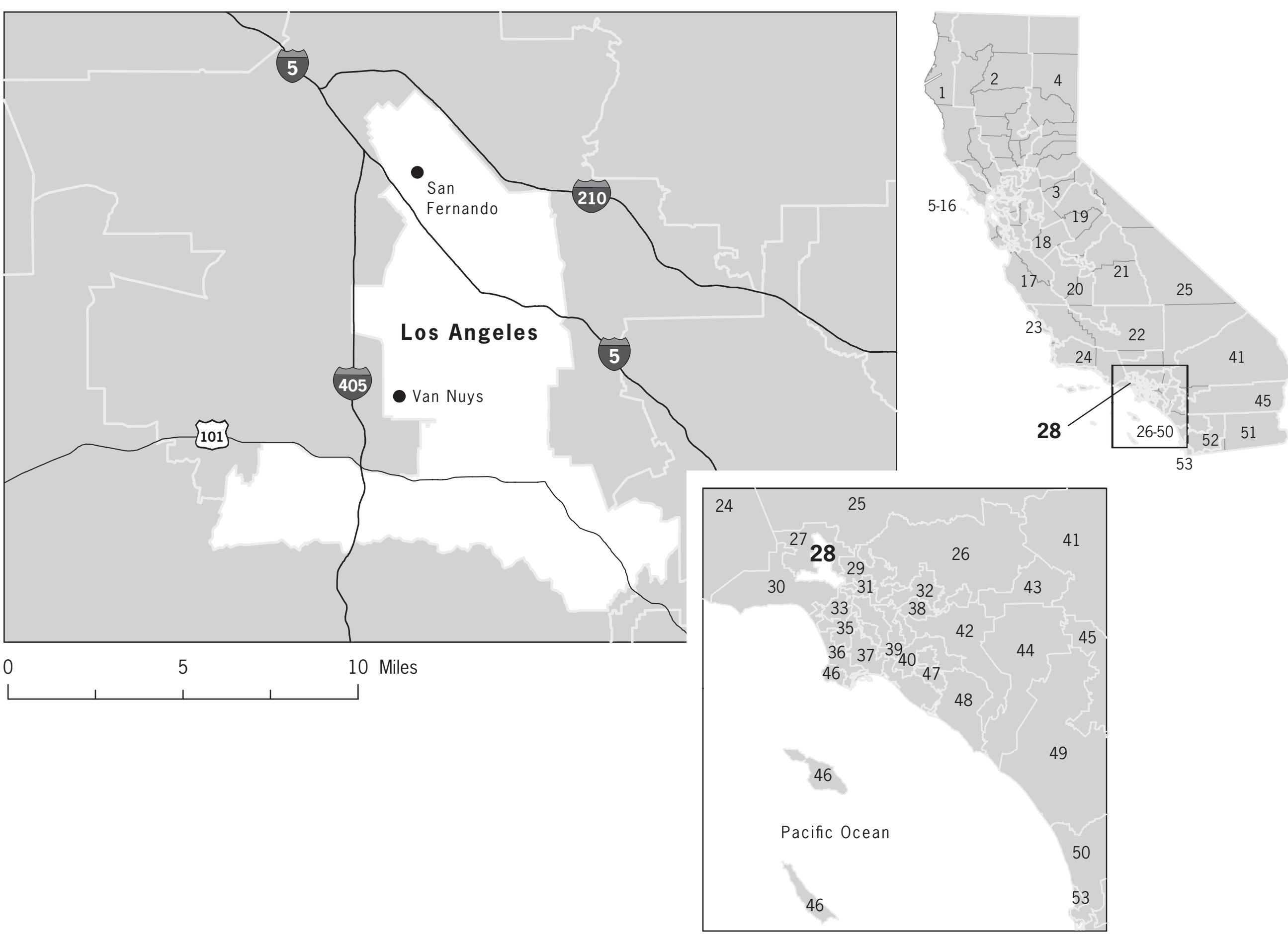
The most far-reaching ballot measure politically was Proposition 20, which reaffirmed the establishment, by Proposition 11 in 2008, of an independent Citizens Redistricting Commission. That year, Prop 11 took the job of redistricting the state legislature after the 2010 Census away from the legislature and gave it to the Commission. In November 2010, voters expanded the role of the Commission by also giving it redistricting authority over California's Congressional districts. Prop 20 passed with a 61% to 39% majority.

Every county in the state voted in favor of Prop 20, except for San Francisco. There the vote was 47% to 63%. And, as if to underscore their support for neutral redistricting, voters rejected Proposition 27, which would have abolished the Redistricting Commission, with only 40% of the voters in the "yes" column.

For once, the dolphins, condors, and snapping turtles agreed on a political reform. Prop 20 has the elements of many a populist reform, deep distrust in government and politicians. But it may well achieve its intended effects and help elect more moderate Democrats and Republicans who will be more inclined to compromise and less fixed in gridlock-producing absolute positions.

This moderating force of Prop 20 should be evident most significantly in primary elections. Primaries are known for low voter turn-outs and for attracting the most passionate and extreme of the condor and

**Figure 1. Congressional District 28**

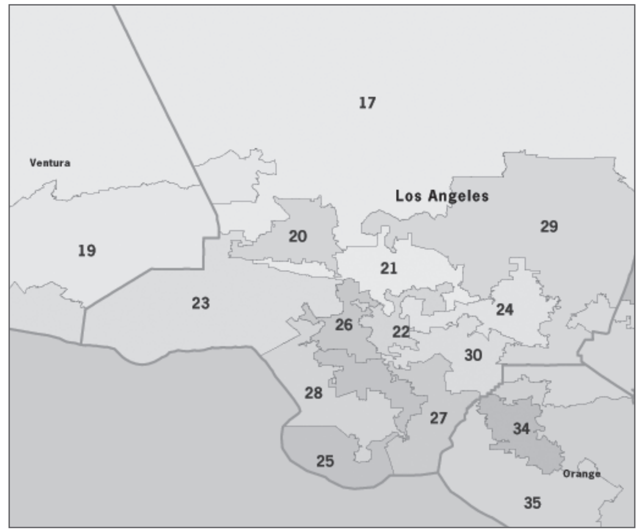


dolphin voters, who (until Prop 14 takes effect) must take either a Republican or Democratic ballot. This system has long been criticized as favoring not only incumbents, but extreme incumbents, who win by turning out the angry base, while many moderately-interested, young, working, and minority voters stay home. Knowing the primary election voting patterns in his or her district and having a say in carving out the neighborhoods where he or she is weaker, goes a long way in winning elections.

For example, **Figure 1** shows the hat-shaped Congressional District 28, which was drawn by Michael Berman, a consultant hired by the Legislature. District 28 is represented by his brother, Representative Howard Berman.

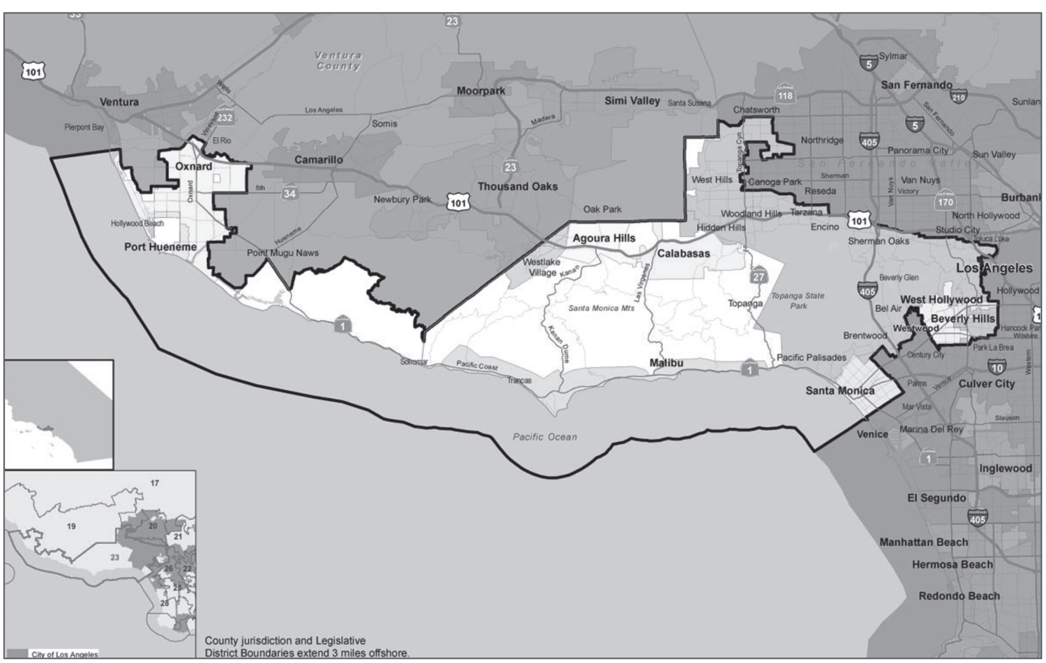
State legislative districts are no different from Congressional districts in their novel geometric and amoeba-like forms. **Figure 2** shows state senate districts from the Los Angeles area. Note, for instance, Districts 28 and 22.

**Figure 2. State Senate Districts From the Los Angeles Area**




As a last illustration, **Figure 3** depicts the 23rd State Senate District, represented by Fran Pavley (who, to be fair, did not draw the District's lines). It stretches from Santa Monica north to Oxnard, and east over a mountain range, stopping just short of Thousand Oaks, a condor nest. Oxnard, however, far away from Santa Monica, is a heavily Latino community that votes dolphin, but it is located in Ventura County, which

**Figure 3. 23rd State Senate District**



is mostly white and conservative. Much of Ventura County is located in Senate district 19, which reaches up to Santa Barbara. That Senate District is represented by Tony Strickland, a Republican who won his last election by 857 votes and certainly would have lost if the district had included Oxnard.

This kind of gerrymandering will be very difficult to achieve under the rules of Propositions 11 and 20. The Citizens Redistricting Commission must adhere to guidelines to "maintain communities of interest, promote geographic compactness and contiguity, and minimize the splitting of counties and cities." The Commission's plan is also mandated to be consistent with the federal Voting Rights Act. (The issue of compliance with that Act could well lead to litigation challenges to whatever plan the Commission enacts.) Proposition 11 also mandates promoting, where possible, the practice of "nesting" two Assembly districts within each Senate district and 10 Senate districts within each Board of Equalization district. The Commission cannot consider the residency of any incumbent lawmaker in designing the districts. It cannot discriminate for or against an incumbent political candidate or political party.[14]

In short, the voters—in the past three elections—have instituted significant electoral reform with the passage of redistricting and open primaries. By 2012, many—not all—candidates will find themselves in much more heterogeneous political districts. To win in open primaries in these districts, these candidates will have to appeal to a wider range of political values and interests. That appeal will require different political temperament, proponents of these reforms hope. They are looking for an approach by candidates that is less ideologically unyielding and one more willing to accept compromise to satisfy a wider swath of voter interests. That change in approach, if it occurs, could help ease gridlock in Sacramento.

## 2011: A SLIGHTLY NEW POLITICAL LANDSCAPE

In 2011, California will continue to be in a terrible fix, with high unemployment, economic stagnation, political gridlock, and a state government barely able to perform its basic tasks and functions. The reasons are complicated, largely structural, but there is plenty of political blame to go around. A century of "ballot box budgeting," of which Proposition 26 was a good example, holds the Legislature to mandated formulas. Federal guidelines on such programs as Medicare and Medicaid, subject to soaring health care costs as the population both grows and lives longer, also dictate spending.

It is difficult to raise new revenue when a two-thirds majority is required for tax and, now, fee increases, particularly when the minority has taken an oath against new taxes and fees. Compared to other states, California is over-reliant on the capital gains tax, creating boom and bust cycles of state budgeting reflecting the stock market. The state has generous public employee pensions whose funds were especially hard hit in the series of stock market collapses. The list goes on and on.

The items on the list are politically fixable, but the major reason they are not getting fixed is the gridlock caused by the deep divides among voters. Voters have elected legislators who reflect the partisan and ideological gulf between the dolphins and the condors. After 2012, with redistricting and open primaries, California may see some ideological softening in the Legislature. The enigmatic Jerry Brown as governor may then be able to find some of the common ground he seeks. But it is hard to see

how anyone could mobilize bipartisan support for the kind of large-scale reforms and changes that could break the logjam.

A look at the last six years illustrates the profound difficulty facing Brown. In 2003, California, with a governor whose approval ratings were in the mid-20% range and a problem of financing a large accumulated short-term budget debt, held a recall election and brought in a charismatic outsider, Arnold Schwarzenegger. One of the first things Governor Schwarzenegger did, although he had vowed to "rip up the state's credit card," was to call a special election. The purpose was to put $15 billion in bonds on the ballot, long-term borrowing to tide the state over until it could get on its feet.

The voters passed two propositions enabling the borrowing in 2004. Six years later, Governor Schwarzenegger has approval ratings in the mid 20% range, the same as his predecessor. Meanwhile, the Legislative Analyst's Office (LAO) now estimates the budget deficit to be in the vicinity of $19 billion plus another legacy of debt of about $6 billion in the general fund that must be financed. Payments to cover the interest on those 2004 Economic Recovery Bonds are one of the contributing factors, although the major factors are the Great Recession and prior failures to correct what is termed the "structural deficit."

At his post-election press conference, Governor-elect Brown, who had pledged not raise taxes without putting it to the voters first, referred to the ballot initiatives that had also been enacted. "The taxpayers gave," he said, "and they also took away. On one hand, the people said by a majority, 'Give us a budget.' On the other hand, they said, 'Don't pick my pocket.'" Pointing to voters' rejection of Proposition 21, which would have created an $18 vehicle-license fee surcharge to fund state parks, Brown said: "The voters last night turned down a mere $18-a-year car tax by about 60 percent, so I would say that the electorate is in no mood to add to their burdens."[15] That view probably takes a tax hike off the table.

Meanwhile, unemployment remains high, poverty rates have risen, and public colleges and universities are continuing to increase fees. Prisons are overcrowded and subject to costly court mandates. At the local level, teachers, firefighters, and police are being laid off, while libraries are shortening hours and cutting days. It is hard to imagine resolving the state's budget problem only through further spending cuts.

## CALIFORNIA HAS BEEN HERE BEFORE

It may be comforting to note that California has been this divided and broke before. dolphin–condor cleavages are deeply rooted in the state's politics. The first third of the last century was a time of outright warfare between workers and capitalists from the ports to the farms of the central valley. Suspicions and prejudices were rampant against Mexicans, Chinese, and Great Depression-era "Okie" migrants from the southwest, Texas and Oklahoma. Fear of Communist "agitators" rose to a level of paranoia.

In 1934, the Democratic candidate for governor was the crusading writer Upton Sinclair, who ran on an "End Poverty in California" (EPIC) campaign that seems, in retrospect, Hugo Chavez-like in terms of its wealth redistribution planks. The Republican candidate was incumbent Governor Frank Merriam, an "exacting, humorless, Red-baiting numbers cruncher from Iowa," according to California historian Kevin Starr.[16] Merriam won.

But things were so bad in the mid-1930s that Governor Merriam found himself pushing through the state's first income tax and raising the state sales tax to three percent. Merriam was brutally opposed in this effort by

a former ally, the influential newspaper tycoon William Randolph Hearst. Hearst financed a sweeping anti-tax referendum that called for repeal of Merriam's taxes and a two-thirds *popular* vote for any tax increase. The Hearst referendum was defeated, but so, too, two years later, was Merriam, by a landslide. And from there state politics only became messier until World War II spending led to an economic boom. But somehow California survived the Bad Times and even prevailed.

The somehow was from a parallel force, often operating outside of the constraints of state government, in the midst of an economic Depression far worse than the current downturn. It was comprised of a combination of activist, reform-minded Progressivism, technical know-how, and awe for engineering. Despite the Great Depression, the state managed to harness the power of the federal government for California's benefit and built brilliant physical infrastructure that sustains the state to this day.

Interestingly enough, one of the people at the very center of that force was Herbert Hoover, mining engineer, savior of the poor in Central Europe after World War I, powerful and effective secretary of commerce under President Coolidge, and failed president in the early years of the Depression. Hoover never held political office in California, but his political fingerprints can be found on every major concrete and steel construction of his time. His operating vision, shared by many Democratic and Republican progressives of his day, was for "associationism" a "planned society in which the three elements—capital, labor, and government—cooperated with each other, under government's direction, to insure productive stability."[17] And in California, at a critical time, it worked.

In historian Kevin Starr's volume on the Great Depression in California, *Endangered Dreams*, there is a striking passage that speaks to the power of this engineering-driven progressivism and "associationism." In 1936, by then former president, Hoover was called on to dedicate the San Francisco-Oakland Bay Bridge. "In his dedicatory remarks," Starr wrote, "Hoover referred to the San Francisco-Oakland Bay Bridge as 'the greatest bridge yet constructed in the world.'"

"Hoover was correct," continued Starr. "In the midst of the Great Depression—as if Hoover Dam, Parker Dam, the second Los Angeles Aqueduct, the All-American Canal, the Hetch-Hetchy Aqueduct, the beginnings of construction on Shasta Dam and the Central Valley project, the Arroyo Seco Parkway, the Rainbow Bridge were not sufficient—the State of California, with a minimum of political controversy, almost casually, without popular vote, completed the single largest bridge in human history and the world's most expensive public work, which gave the City of San Francisco its long-delayed direct connection to inland California."[18]

Indeed, in the ironic words of the theme song to a comedy show about a family of dolphins and condors living under one roof (way back when Jerry Brown was Governor the first time) it may well be that: "Mister, we could use a man like Herbert Hoover again."[19] Or we could use at least a force that could mobilize capital, labor, and government again to fix California's once-great physical and educational infrastructure and start a few audacious projects for the future.

# ENDNOTES

**1** Mark Baldessare, "California's Post Partisan Future" Public Policy Institute of California (PPIC), January 2008, p. 5.

**2** *Ibid*, Baldessare.

**3** *Los Angeles Times*, National and California Exit Poll Results, November 5, 2008.

**4** Peter Schrag, "California at a Crossroads," California progress report, www.californiaprogressreport.com/2007/01/califorjia_at_.html

**5** Demographic, election, and voter information for this article is drawn from the website of the California Secretary of State unless otherwise noted.

**6** California Secretary of State, http://www.sos.ca.gov/elections/ror/ror-pages/15day-gen-10/hist-reg-stats.pdf.

**7** Robert D. Putnam and David E. Campbell, *American Grace: How religion Divides and Unites Us.* (Simon and Shuster: New York, 2010), pp. 369-418.

**8** The California Department of Finance is the source of the Latino, Asian, and African American estimates in the text as of mid-2008. See http://www.dof.ca.gov/research/demographic/reports/estimates/e-3/by_year_2000-08/documents/Final%202008%20Race%20Ethnic%20Estimates%20Report%20Tables.xls. The California Field Poll estimated the figure in the text for likely Latino, Asian, and African American voters just before the November 2010 election. See also http://www.sos.ca.gov/elections/ror/ror-pages/15day-gen-10/hist-reg-stats.pdf. (The likely voter estimate for Asians is actually for Asians/Others.). But see footnote 10 for an estimate of actual votes in November 2010.

**9** Mark Baldessare, "Californians and Their Government," Public Policy Institute of California, December 2009.

**10** In a *Sacramento Bee* exit poll, the proportion of Latinos voting was given as 22%. Note that this figure suggests that Latinos voted at a significantly higher rate than the "likely voter" estimate of the Field Poll. See http://www.sacbee.com/2010/11/04/3160768/how-california-voted-exit-polling.html. Some of the discrepancy may result from the growing fraction of voters who mail in absentee ballots. Latinos may be underrepresented in mail ballots and therefore overrepresented in exit polls.

**11** George Skelton, *Los Angeles Times*, February 11, 2010, http://articles.latimes.com/2010/feb/11/local/la-me-cap11-2010feb11

**12** Exit poll data from http://www.sacbee.com/2010/11/04/3160768/how-california-voted-exit-polling.html.

**13** Some exit poll in the text citations are drawn from the *Los Angeles Time*s. They were conducted by Edison Research and are not available to the public, only to media subscribers

**14** Text of Proposition 11, Article 21, Section 2, Subdivision d.

**15** Debra Saunders, SFGate.com, November 4, 2010. http://articles.sfgate.com/2010-11-07/opinion/24818396_1_jerry-brown-budget-shortfall-voters-last-night

**16** Kevin Starr, *Endangered Dreams: The Great Depression in California* (Oxford University Press, New York, 1996), p.149.

**17** *Ibid*, Starr, p. 76

**18** *Ibid*, Starr p. 329

**19** Lee Adams and Charles Strouse, "Those Were the Days" (song). Lyrics at http://www.mortystv.com/aitf_faq.shtml. The song was composed in 1971 as the theme for the TV show "All in the Family."

# 3

# CALIFORNIA'S ECONOMIC OUTLOOK


## CHRISTOPHER THORNBERG

## JON HAVEMAN

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This chapter reflects information through late September 2010.

*During the summer of 2010, the National Bureau of Economic Research (NBER) declared the recent recession that began in December 2007 ended in June 2009. The popular press largely panned this pronouncement, saying that it is out of touch with Main Street where the pain of the downturn is still being felt. But this criticism is due to a fundamental misunderstanding of what the NBER was actually dating.*

## DEFINING A RECESSION

A recession in economic terminology occurs when there is a substantial broad-based reduction of economic activity, as measured by a number of indicators ranging from industrial production to employment to overall real GDP. A recession is technically over when the contraction comes to an end—not when the economy gets back to its pre-recession level of economic performance.

For economists who regularly watch the numbers, it was pretty clear by mid-2010 that the recession had been over for quite some time—the only question was the exact date the NBER might choose. The recovery is another story and has been slower than policymakers or Main Street would like (particularly in the labor markets). However, this outcome is not surprising.

## A CHOICE TO SPREAD THE PAIN

Beacon Economics has been publicly forecasting a slow recovery. The slowness of the recovery is as much an artifact of policy decisions as it is of the nature of the downturn. It is clear that the policy choices that were made achieved stability and an earlier recovery by pushing a portion of the economy's problems into the future.

The benefits of such a strategy are clear. An economy facing too many negative hits can sink into a death spiral of reduced demand and output, something that can lead to a long-term depression. By spreading the pain out over time, the chance of such a negative feedback cycle was reduced. But the choice also prevented the sort of rapid recovery the Obama administration desired.

## SLOW RECOVERY, BUT NO DOUBLE-DIP, ANTICIPATED

There have been fears of a double dip recession, particularly during the summer of 2010, when the slowing pace of GDP growth sent shock waves through the equity markets. But forecasters at Beacon Economics never believed this was a realistic possibility. Recessions need some formative shock to occur. Imbalances in the economy that could create such a spark were not visible.

Beacon Economics still expects below average growth rates over the next two years as the Federal Reserve and Congress begin to unwind historically low interest rates and massive budget deficits. California is not an independent economy; it is heavily intertwined with the rest of the U.S. So slow growth nationally means slow growth in California.

U.S. consumer spending is forecast to grow at a slower than normal pace. There is also likely to be continued weakness stemming from both the residential and commercial real estate markets as those markets continue to work through the backlog of excess supply and bad debt. California was hit especially hard by the real estate bust; consequently, its economic performance is impeded by the need to work off this backlog. Employment growth nationally will continue to be moderate, implying that it could be late 2013 before employment levels at the previous peak return and late 2014 before unemployment drops below 6% again. The news isn't all bad. These weaknesses are being offset to some extent by growing exports (and California is both an exporter and the home to seaports and airports that carry international trade). There are also decent trends in business investment in equipment and software.

## INTEREST RATE OUTLOOK

The biggest worry for forecasters is interest rates. Rates are currently at near record low levels, which has done wonders for stabilizing the economy. However, as is the case of many strong medications, low interest rates have the potential to incur a damaging dependency in the patient. These low rates can't possibly be maintained given our fundamentals—the massive increase in the monetary base by the Federal Reserve and a truly terrifying federal budget deficit. The trick is to remove the monetary stimulus and close the budget deficit before inflation or sovereign debt default fears spook the markets, causing an explosive increase in interest rates. Nonetheless, these threats are at least a year out, and probably even more. But the solutions to this public-sector bubble need to be applied sooner rather than later in order to ensure an orderly withdrawal.

Still, the worst is over. But there are still risks, if not for a double-dip, at least for a slowdown of an already-sluggish recovery. In the following pages we discuss some of the major headwinds for the economy—and where the greatest risks lie for another slowdown.

## CONSUMER SPENDING RISKS

A key feature of the Great Recession was the sharp decline in consumer spending. One of the consistent mantras from policymakers and economists has been that the economy can't fully recover until consumer spending starts to grow again at a normal pace. While this sentiment is correct, Beacon Economics does not subscribe to the idea that soft consumer spending is a function of weak labor markets, a lack of confidence in the economy, a lack of easy credit, or any other problem that needs a traditional policy prescription.

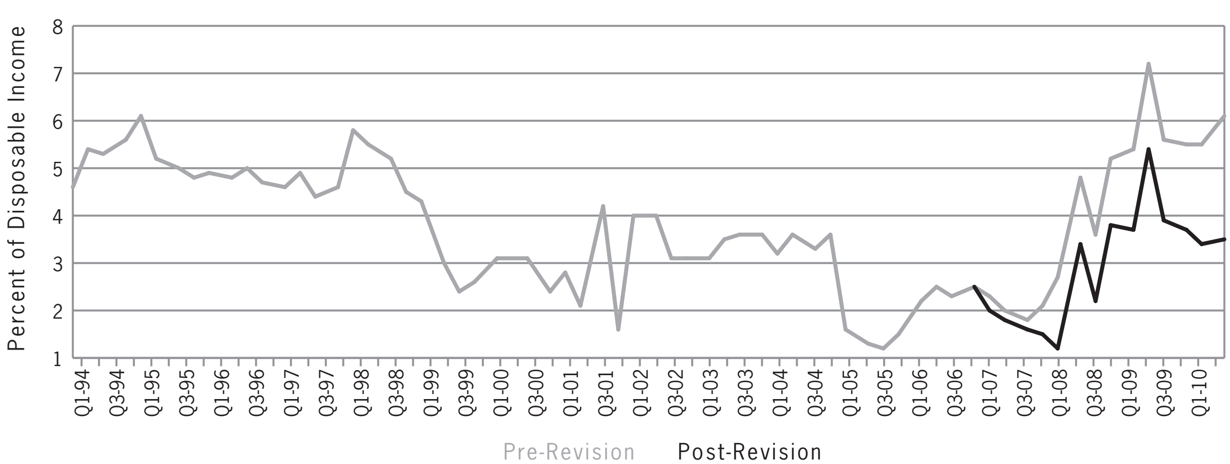
Today's situation is different. This time, declines in consumer spending are the natural consequence of years of over-spending . Unfortunately, as a share of the overall economy, consumer spending needs to fall even farther before the economy can return to a normal, sustainable path.

One of the drivers of this downturn was the sharp appreciation in asset values in the United States between 1994 and 2007 (only one-third of which was related to residential real estate, although undoubtedly more so in California than in the rest of the U.S.). The sudden increase in the net worth of households was one of the primary drivers of the drop in the private savings rate (from 6% to 1% of disposable income) and the large increase in the international trade deficit over the same period of time.

When asset prices fell back toward long run levels in 2007, it was clear that the American consumer had to begin saving again at an appropriate level. That need meant a permanent decline in spending relative to income as part of a full recovery. Once this decline occurs, consumer spending can then start to grow at a normal pace.

Early reports of consumer behavior during the downturn indicated that consumers were responding only by very slowly increasing their saving. But revised GDP numbers indicated that the decline in consumer spending during the recession was much larger than had previously been thought. The earlier data had indicated that consumers still had a long way to go, while the new data indicate that their response has been much more complete, with savings rates increasing from roughly zero before the recession to near 6% of disposable income.

**Figure 1. U.S. Personal Savings Rate Q1-94 to Q2-10**




Source: U.S. Bureau of Economic Analysis

On top of this, while the labor markets remain weak overall, there are clear signs that things are on the mend. Job growth—after factoring out the hiring and layoff of federal Census workers, has been slow been visible during the recovery. The sluggishness in job growth should not be a surprise—"jobless recoveries" are the new reality of business cycles. Indeed the nation continued to lose jobs for almost 18 months after the 2001 recession ended in September of that year.

Of the over 7 million workers who lost their jobs in this downturn, over half were in manufacturing and construction. Many manufacturing workers will see their jobs replaced with capital investments. Construction workers will face years of below-average construction activity because of the real estate bust. Thus, while the labor market will be improving, there will exist a large group of workers who will require more time before they can reintegrate into the workplace. And when they do, many will be in lower paying jobs.

## TAXES

The job issue is a long-term concern. In the short-term, a major concern is that the current "normal" saving rate is a function of abnormally low tax rates that were put into place partly by the Bush tax cuts, partly by the current administration's stimulus program, and partly by the self-regulating nature of a progressive tax system. Tax rates at this writing were running at approximately 9% of total income, considerably lower than the long run average of 12%.

At the very least, the massive expansion of the federal debt is an injustice to the next generation of taxpayers who are already facing a massively underfunded social insurance system. At worst it could eventually lead to a Greece-type fiscal crisis. No, we don't like paying taxes. But borrowing doesn't fix budget problems either—it only hides them from taxpayers' personal balance sheets. This is not to say that there should be a full increase in tax rates

**Figure 2. U.S. Private Employment Trends 24 Months After End of Recession**

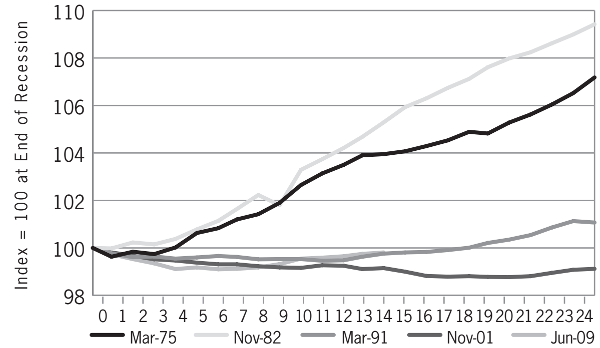
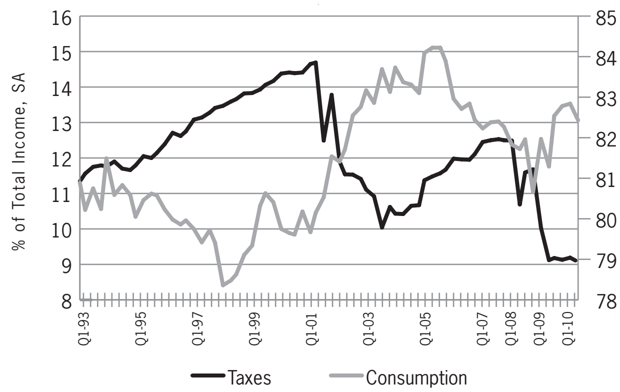



**Figure 3. U.S. Personal Tax Rate and Consumption Q1-93 to Q2-10**



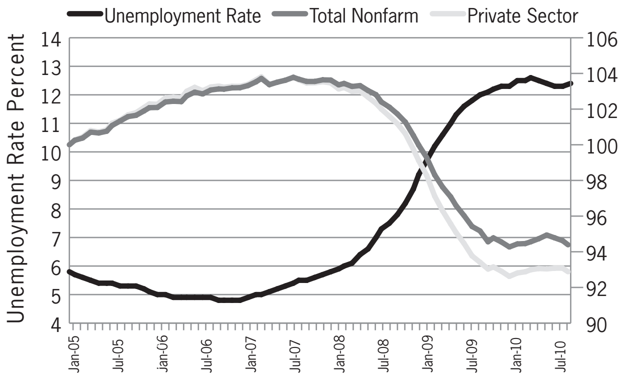

Source: U.S. Bureau of Economic Analysis

to historic levels overnight—this would surely cause a double dip as consumers would cut spending sharply.

But taxes must eventually go up, and starting from high-income earners down makes the most sense from a policy perspective. We have time to do this—levels of outstanding debt are still far below 100% of GDP—a level that economists look at as a turning point for international bond investors. But running a deficit of 10% per year implies that the nation will get there faster than anyone would like.

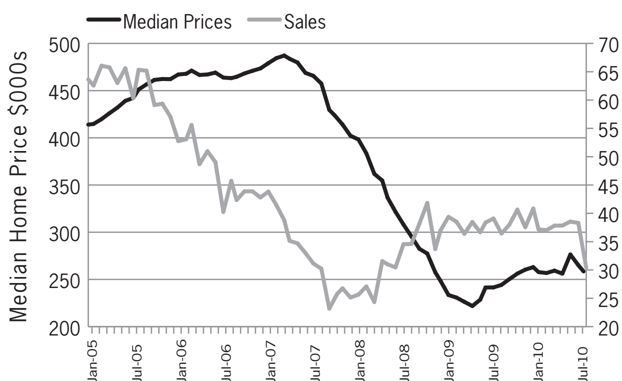
The best part of higher taxes is that as Americans begin to pay them, they will hopefully start to pay more attention to the spending binge that has been going on in Washington, DC. At the end of the Clinton years, both

**Figure 4A. California Labor Markets**
**Jan 05 to Aug 10**



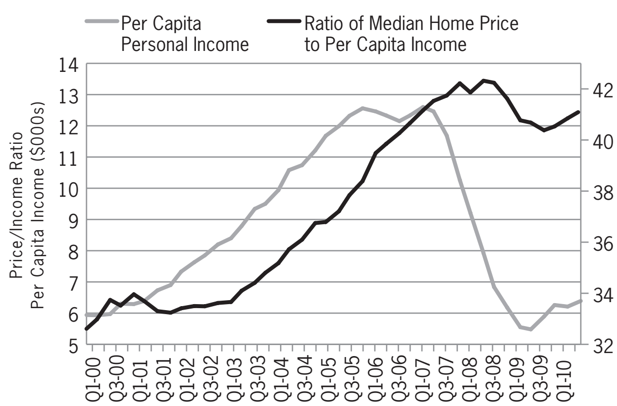

Source: California Employment Development Department

**Figure 4B. California Housing Markets**
**Jan 05 to Jul 10**




Source: DataQuick

**Figure 5. California Housing Fundamentals**
**Q1-00 to Q2-10**




Source DataQuick, CA Department of Finance, U.S. Bureau of Economic Analysis

direct federal spending as well as total expenditures had hit record low levels. Then a federal spending boom began during the Bush II administration.

## THE CALIFORNIA FORECAST

Beacon Economics sees indications that California has weathered the worst of the Great Recession. The road back to full recovery, however, is going to be a long one. At this writing data on economic output in California are not available but we are fairly confident that the state has begun to grow again but *slowly*.

## HOUSING

There were some predictable developments in the California housing market that caused some observers to call for a severe double dip in the state's real estate sector. The major source of these fears was a sharp drop-off in home sales in California during the summer of 2010. Although large in magnitude, this slowdown was wholly expected and coincides with the expiration of the federal government's tax credit for homebuyers.

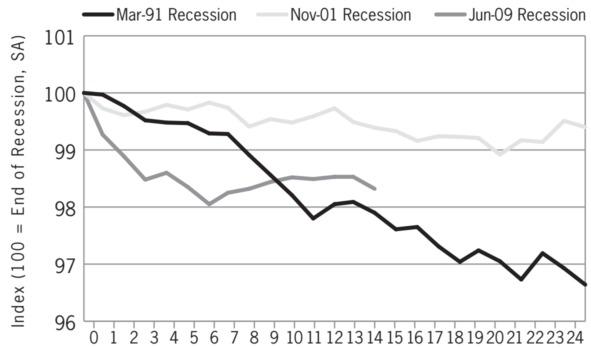
Home prices are not going to rocket back to pre-recession peaks anytime soon. But fears of a significant double dip in home prices are likely exaggerated. The fundamental drivers of long-term home prices paint a picture of a housing market that has emerged from the collapse and is now healthier. Home prices have largely stabilized. Additionally, measures of affordability show that California appears poised for slow but steady growth once its labor markets have healed. At roughly 6-times per capita income in the state, home prices are beginning to make sense again for typical homebuyers. As income continues to grow at a moderate pace, home prices will likely follow suit at a more tepid but sustainable pace.

## THE JOBS PROBLEM

California's labor markets make it easy to understand why the downturn is termed the Great Recession. After peaking at 15.2 million jobs in November 2007, the state shed almost 1.4 million nonfarm positions by December 2009. To this writing, California has added only a small number of jobs in Education/Health Services, Administrative Support, Manufacturing, Retail, and Other Services. These gains, however, are small relative to how many jobs have been lost, leading many to dub this another "jobless recovery"—stoking fears of a double dip recession in California, even if one did not occur nationally.

However, despite its modest job growth, California has been plugging along a similar path of job growth to that experienced during the previous two jobless recoveries. Compared to the last two downturns, California lost more private sector jobs in the first six months after this recession officially ended and then showed some growth in employment. Recoveries accompanied by speedy job growth (such as in the 1975 and 1982 recessions) may well be a thing of the past for California.

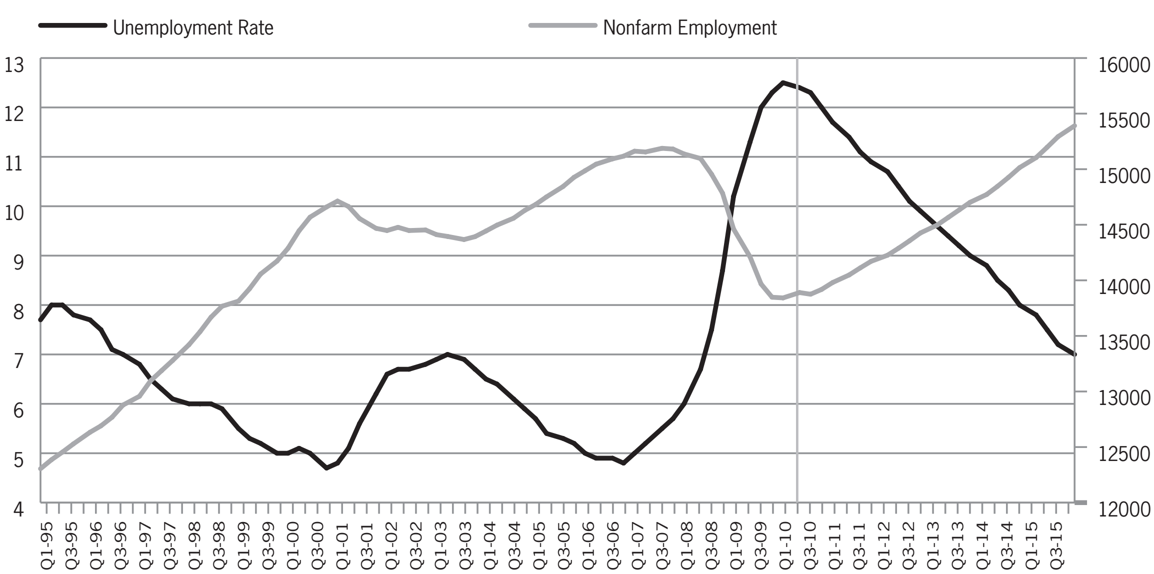
**Figure 6. Post-Recession Private-Sector Employment California, Last 3 Recessions**




Source: National Bureau of Economic Research

The 1991 and 2001 recessions were due to structural changes in the California's economy. In 1991, there were structural adjustments because of the loss of the aerospace industry with the end of the Cold War. In 2001, the dot-com boom became the "dot-bomb" and more adjustments were required. The recession that began at the end of 2007 was more cyclical in nature than was the case in 1991 or 2001. Yet, the similar pattern of weak job growth in the past three recessions is an indication that jobless recoveries are the new normal than an indicator of a pending double dip.

**Figure 7. California Labor Market Forecast Q1-95 to Q4-15**




Forecasts by Beacon Economics

At the writing, it appears that the pace of the jobs recovery is roughly on par with what occurred after the 1991 downturn. Total nonfarm employment in California is expected to breach the 14 million milestone in 2011. But it won't reach its pre-recession peak of 15.2 million until mid-2015. Expect the unemployment rate to remain at or above 12% through the end of 2010, and not fall below 10% until the end of 2012.

California has made it to the bottom of this business cycle. The question is how fast will the recovery progress? As noted, Beacon Economics continues to forecast slow, steady growth, but with the caveat that many serious issues remain.

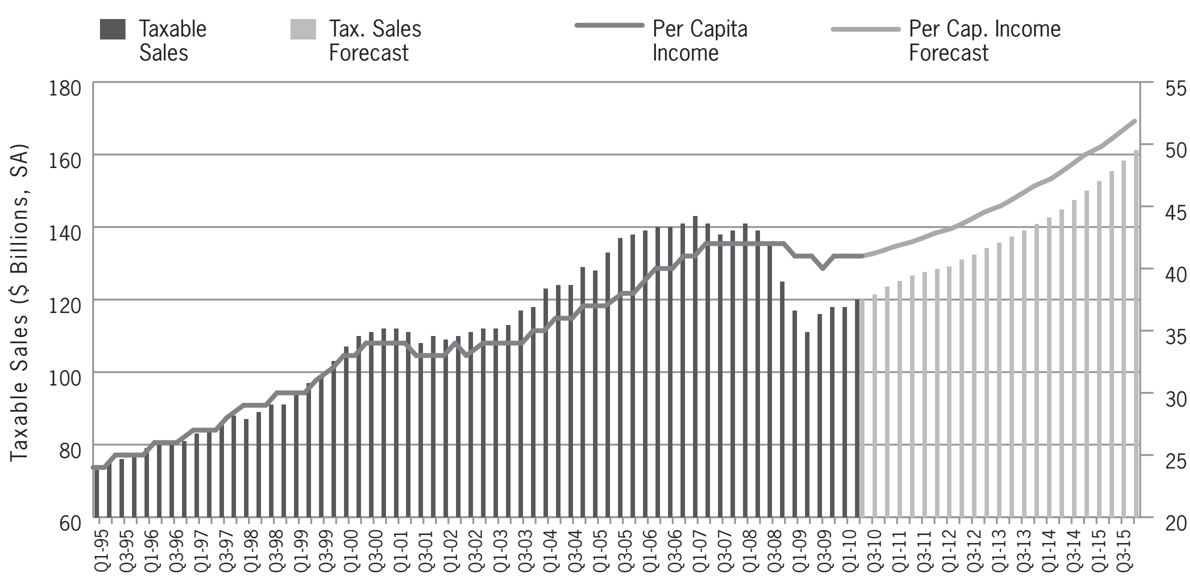
## CALIFORNIA CONSUMERS

Consumer spending in California has shown solid growth at the time of publication. Much of the growth was stimulated by intervention in the markets by the federal government. First, the increase in home sales associated with the first-time homebuyer tax credit, bolstered demand for both durable and nondurable goods needed to furnish these homes. There have been cash-for-clunkers programs for cars and appliances at federal expense.

Second, the Federal Reserve has kept interest rates at near-zero for an extended period, which (holding everything else constant) reduces the incentive to save versus spend. Third, although there have been some boosts in state and local taxes in California, federal fiscal policy has continued to provide tax breaks to consumers. Thus, California's consumers have more of their gross income available for consumption than in recent years.

Because government policies are largely behind the jump in spending, many question the sustainability of the recovery. However, the U.S. Bureau of Economic Analysis (BEA) released revised estimates of consumer spending that show consumers' balance sheets are in slightly better shape than initially reported, which paints a slightly less grim picture for California.

**Figure 8. California Taxable Sales Forecast Q1-95 - Q4-15**

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This consumer stimulus (with federal intervention), combined with slightly improved labor markets, explains why—as of this writing—taxable sales in California continued to improve. Indeed Sacramento has benefitted from this trend, with much of the improvement in the state's cash position due to better results on sales tax receipts.

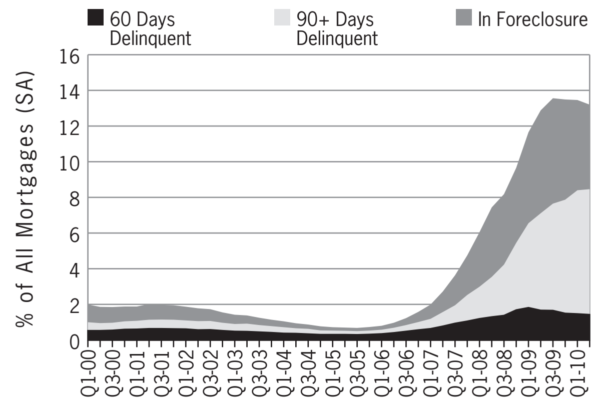
## TAXABLE SALES

Beacon Economics forecasts that taxable sales in California will continue to grow, although there are some risk factors on the horizon. As noted, tax rates are at nearly all-time lows, and government intervention is relatively high. This situation has created serious concerns over the federal deficit and sovereign debt issues here in the United States. At some point, the government will have to pull back its spending and raise the personal tax rate in order to address the federal deficit. As tax rates rise, consumers in California will find less of their incomes in their bank accounts, which could have an impact on taxable sales growth.

Beacon Economics is forecasting that taxable sales will grow between 4% and 5% on an annualized basis over the 2011, but will drop to roughly 3.5% in nominal terms in 2012 as the government pulls back. As the economy adjusts to these fiscal changes, taxable sales growth will return to the 4% to 7% range per year in 2013 and beyond.

Part of the negative impact associated with the government pull back will be offset by rising incomes. Per capita income has begun rising again slowly in California after dropping to just $40,000 per year. This trend should continue as labor markets heal further, supporting a forecast of slowing growth in taxable sales rather than a double dip.

**Figure 9. California Distressed Mortgages Q1-00 to Q2-10**




Source: Mortgage Bankers' Association

## SECOND HOUSING STORM OVERBLOWN

Fears over a major double dip in home prices are likely misplaced. There is no doubt that demand for homes fell (as measured by home sales) after the federal homebuyer tax credit expired. The drop in demand led to some weakness in price; but the fundamentals all indicate that California's real estate market is emerging from this recession in a healthier position. Home prices have returned to their long-run, and far more sustainable, trend of roughly 6-times per capita income.

Of course, the downturn wreaked havoc on the balance sheets of many Californians. These folks saw their primary asset (their home) fall in value by an average of 57% between the 1st quarter of 2007 and the 2nd quarter of 2009. No doubt, this reduction in perceived wealth has certainly played a role in the consumer pullback noted earlier.

It is important to point out that while indicators such as the affordability of homes show that the market is returning to fundamentals, there are many problematic issues remaining. The primary issue is the number of distressed mortgages remaining in the system.

According to the latest data available at the time of publication from the Mortgage Bankers' Association, more than 13% of all mortgages in California remain seriously delinquent (60+ days delinquent or in foreclosure).

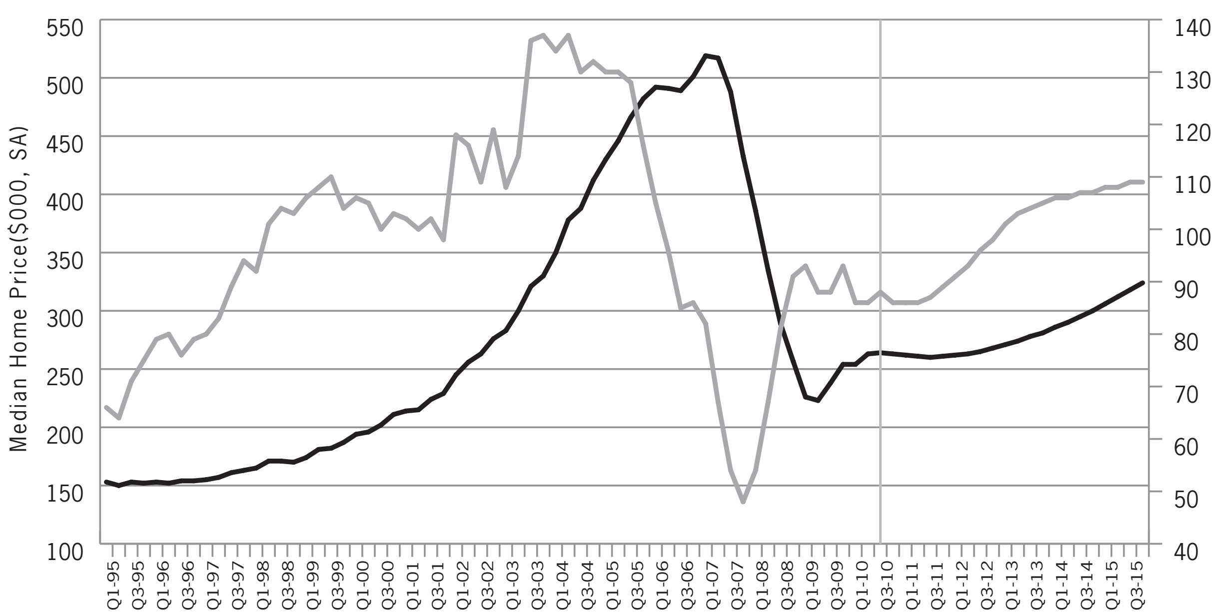
These issues need to be worked through, either by modification of the terms of the mortgage or by allowing the units to foreclose, before the housing market can return to a normal pattern of growth. Real estate in California will remain weak over the next year as the industry works through the distressed mortgage and labor markets slowly gain steam. Home sales activity will be soft as federal incentives are no longer in place and uncertainty over job growth persists.

However, as the unemployment rate dips below 10% in 2012 and incomes grow, home sales will start to rise back into the 100,000 per quarter range again. Similarly, relatively flat home prices in the short run will begin to rise as demand for homes increases over the medium term. In the future, expect modest growth in home prices that are in line with fundamental price drivers: incomes, population growth, and relative the economic strength of California's labor markets. By 2015, median prices will be back in the $300,000s–– well below the 2006 peak, but providing a much more sustainable platform for growth.

## CONCLUSION

California's housing markets weathered a bad storm, but growth—slow growth—is on the horizon. The same is true for the state's labor markets and for taxable sales. We don't forecast a double-dip recession for the U.S. or for California. But there is a high level uncertainty due to the dramatic impact of the Great Recession. Much of California's economic performance will depend on the national economy and how policy decisions in Washington are made.

**Figure 10. California Real Estate Forecast Q1-95 to Q4-15**




Forecasts by Beacon Economics

# 4

# CALIFORNIA'S LOW CARBON FUEL STANDARD:

## THE VIEW FROM THE GROUND

MAX MESSERVY[1]

[1] The author is a candidate in the master of public policy program in the UCLA School of Public Affairs. An earlier version of this chapter was prepared as a report for a course on California policy issues.

# 4

California's Low Carbon Fuel Standard (LCFS) was signed into law with much fanfare on January 19, 2007 by an executive order issued by Governor Arnold Schwarzenegger.[2] The goal of the LCFS is to reduce the carbon intensity of the transportation fuels sold in California ten percent by the year 2020.[3] Through a mix of innovative market-based as well as traditional "command and control" strategies, the LCFS seeks to provide a flexible framework for achieving the stated greenhouse gas (GHG) reduction targets that is amenable to, and indeed, is predicated on fuel industry participation.[4]

This chapter evaluates the progress of the LCFS three years after its enactment into law. Specifically, it reviews and answers four questions:

1. How effective will the LCFS be as a regulatory tool for reducing GHG emissions from transportation fuels?
2. How have fuel refiners and producers reacted to the LCFS?
3. How have alternative fuel producers and distributors reacted to the LCFS?
4. What possible effects will the LCFS have on the life of the average California consumer once it is fully implemented?

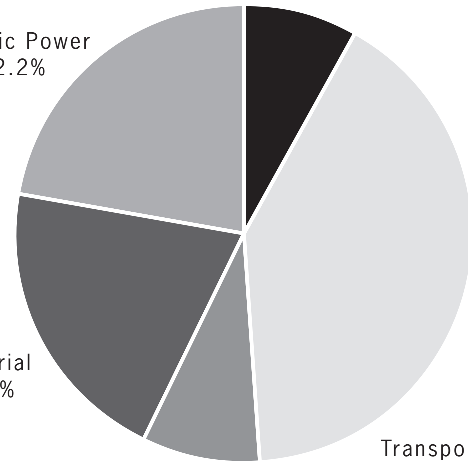
The LCFS represents a new breed of environmental regulation, one that prioritizes flexibility in accommodating the needs of industry while also vigorously working to meet strong regulatory goals. While it is an early stage in the implementation process, an assessment of industry's response to the new LCFS regulations will provide insights into how effectively the regulations will operate once they take effect in 2011,[5] given the effort to make them flexible.

# BACKGROUND ON THE LCFS

## LIFECYCLE ANALYSIS: AN INNOVATION

Reducing the carbon content of transportation fuels through the Low Carbon Fuel Standard is designed to be the "third leg in the stool" of reducing GHG emissions from vehicles, along with increasing vehicle efficiency and reducing the number of vehicle miles traveled (VMT).[6] The LCFS is designed to work in conjunction with AB32, the "Global Warming Solutions Act" that is designed to reduce California's GHG emissions to 1990 levels by the year 2020, or approximately 28 percent below the forecast GHG emissions levels.[7] Under the aegis of AB32, the LCFS mandates that all transportation fuels sold in California reduce their carbon intensity by 10 percent by the year 2020 through fuel providers tracking the global warming intensity (GWI) of their fuels and reducing those values over time to meet set standards.[8] **Figure 1** indicates the scale of the transportation sector's contribution to California's total GHG emissions levels, and it is apparent that even a moderate reduction in the transportation sector would have an outsized influence on California's overall GHG emission inventory:

**Figure 1. Greenhouse Gas Emission Inventory 2005**




Source: Crane, David, and Brian Prusnek. The Role of a Low Carbon Fuel Standard in Reducing Greenhouse Gas Emissions and Protecting our Economy. Office of the Governor of California. http://gov.ca.gov/index.php?/fact-sheet/5155/ (accessed March 1, 2010)

The authors of the LCFS set the standard of measurement of GWI as grams of carbon dioxide equivalent per megajoule of fuel delivered to the vehicle ($gCO_2e$ /MJ); a measurement that is designed to be adjusted to account for different efficiencies of vehicle drivetrains such as electric, diesel and hydrogen vehicles.[9] Through these GWI numbers, the LCFS allows for the banking and trading of carbon credits as a method of incentivizing the production of lower-carbon fuel sources, which are generally more expensive to produce than conventional petroleum-based fuels.[10]

The LCFS is a significant departure from previous efforts to regulate the transportation sector. Whereas California has previously mandated certain fuel quotas or transportation options, such as methanol fuel and zero-emission vehicle (ZEV) sales in the state, the LCFS mandates GWI reduction values each year and then leaves it to the markets to determine the most efficient, cost-effective methods to achieve that reduction.[11] According to Governor Arnold Schwarzenegger's Executive Order S-01-07:

> *The LCFS shall apply to all refiners, blenders, producers or importers ("Providers") of transportation fuels in California, shall be measured on a full fuels cycle basis, and may be met through market-based methods by which Providers exceeding the performance required by a LCFS shall receive credits that may be applied to future obligations or traded to Providers not meeting the LCFS.*[12]

The words "measured on a full fuels cycle basis" codify one of the more revolutionary concepts in environmental regulation into law: emissions are not solely to be measured at the tailpipe, but from "well to wheel." The full fuels cycle measurement, also commonly referred to as carbon "lifecycle analysis" (LCA) seeks to include the emissions generated through the production and distribution of fuels as an integral part of the measurement of their overall carbon intensity, in addition to the act of consuming the fuel for vehicle propulsion.[13]

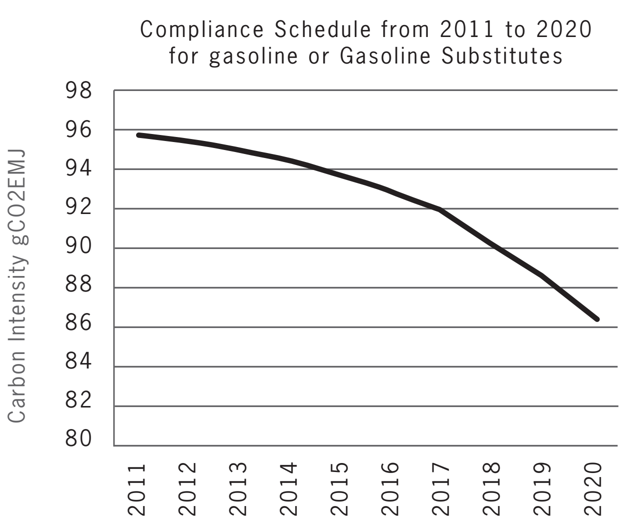
In line with the LCA calculations, an expert workgroup was convened to establish carbon intensity values for gasoline and fuels that substitute for gasoline, as detailed in the Appendix. The values in the table are separated out into "Direct Emissions," "Land Use or Other Indirect Effect," and the total value of both measurements combined. The "land use or other indirect effect" calculation is an attempt to quantify the different "upstream" effects of energy production that have not traditionally been taken into account in measuring carbon emissions.

For instance, gasoline is rated at 95.86 $gCO_2e$ /MJ in direct emissions, with zero land-use effect, for a total of 95.86; Midwest average ethanol from corn, on the other hand, is calculated to have a direct emissions value of 69.40 $gCO_2e$ /MJ, and a land use effect of 30 $gCO_2e$ /MJ, for a total of 99.40 $gCO_2e$ /MJ.[14] The calculations of land use and other indirect effects are some of the more controversial elements of the LCFS, a topic which we will return to in the biofuels section subsequently.

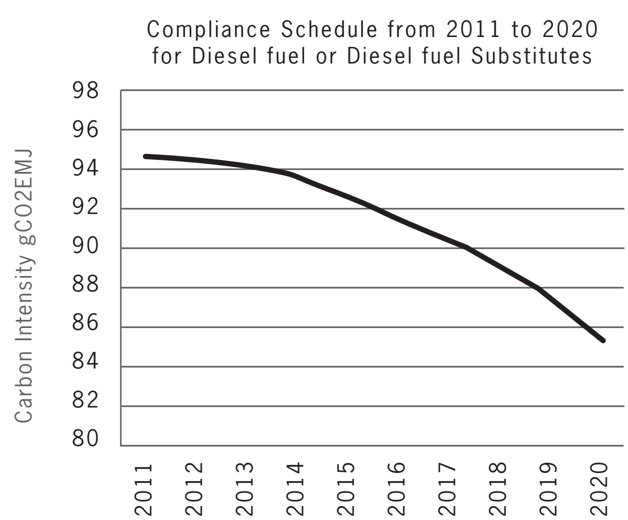
## DISTRIBUTION, TRADING AND BANKING OF CREDITS

The LCFS differs from a cap-and-trade emission trading scheme in that firms producing transportation fuels are required to apply to the California Air Resources Board (CARB) for credits based on how much they exceed the emissions reduction standard set for each year.[15] In order to achieve the 10 percent reduction target, the standard will be lowered on an annual basis as indicated below graphically in **Figure 2**, and numerically in **Table 1**:

**Figure 2: LCFS Compliance Schedule**




Source: California Air Resources Board 2009, VI-3A[16]




Source: California Air Resources Board 2009, VI-3A[16]

**Table 1: LCFS Compliance Schedules** [17]

| | CI for Gasoline and Fuels Substituting for Gasoline (g/MJ) | Gasoline and Fules Substituting for Gasoline % Reduction | CI for Diesel and Fuels Substituting for Diesel (g/MJ) | Diesel and Fules Substituting for Diesel % Reduction |
|---|---|---|---|---|
| 2010 | Reporting only | | | |
| 2011 | 95.61 | .25% | 94.47 | .25% |
| 2012 | 95.37 | 0.5% | 94.24 | 0.5% |
| 2013 | 94.89 | 1.0% | 93.76 | 1.0% |
| 2014 | 94.41 | 1.5% | 93.29 | 1.5% |
| 2015 | 93.45 | 2.5% | 92.34 | 2.5% |
| 2016 | 92.50 | 3.5% | 91.40 | 3.5% |
| 2017 | 91.06 | 5.0% | 89.97 | 5.0% |
| 2018 | 89.62 | 6.5% | 88.55 | 6.5% |
| 2019 | 88.18 | 8.0% | 87.13 | 8.0% |
| 2020 | 86.27 | 10% | 85.24 | 10% |

There would not be a cap on the number of credits the CARB regulators distribute, and firms would apply for the credits annually; the regulators would be solely bookkeepers, issuing allowances to the accounts of regulated entities and moving them from account to account as directed by market participants.[18] Credits would be denominated in large units, such as tons of $CO_2$ equivalent emissions due to firms varying in size, so that a 1 percent emissions reduction by a large firm, which would produce a large reduction in the absolute amount of $CO_2$-equivalent emissions, is weighted differently from that of a smaller firm.[19]

Fossil fuel suppliers are required to reduce the average GWI of their fuels sold from the year 2011, which will incentivize gasoline and diesel producers to purchase credits from renewable fuel manufacturers, thus stimulating the demand for the development and production of alternative fuels.[20] Furthermore, the LCFS will promote regulatory and economic certainty among alternative fuel producers, as they will be assured that there will be a demand for their products under the LCFS.[21] The baseline year that that LCFS sets for making its calculations of average fuel carbon intensity (AFCI) across all of California is 2005, which the authors calculated as 88 $gCO_2e$ / MJ, meaning that a 10 percent reduction in that figure by 2020 would reduce the AFCI value to approximately 79.2 $gCO_2e$ / MJ by the year 2020.[22] The Governor's Office estimates that the LCFS target of a ten percent reduction in carbon emissions would result in a 20 percent reduction in the use of petroleum fuels, with an equivalent increase in non-petroleum fuel use.[23]

# FUEL REGULATIONS

## REGULATIONS FOR PETROLEUM-BASED FUELS

Within the GWI calculations for the two "traditional" fuels gasoline and diesel, the regulations stipulate that the calculations are based on the "average crude oil delivered to California refineries and average California refinery efficiencies."[24] Here is where the flexibility of the LCFS comes into play, as to meet the target carbon reduction level, oil companies can improve the efficiency of their refinery or upstream production operations, blend low-carbon biofuels into their gasoline products, purchase credits from low-carbon fuel producers, or begin to sell low-carbon fuels of their own.[25] Once fuel producers can prove that they have lowered the GWI average of their products beyond the standard for that year, then they can apply for credits from CARB regulators, as was noted above.

More specifically in regards to petroleum, the authors of the LCFS framework, Alex Farrell and Dan Sperling, designed the LCFS as a response to recent industry investments in carbon-intense fuels;

what they term “unconventional” resources: heavy oil, tar sands, oil shale, and coal.[26] The “peak oil” concept underlies the authors’ assumptions in regards to petroleum production. Peak oil is the idea that petroleum production has reached its maximum, or peaked, and that from present times on, oil extraction will be increasingly expensive due to the fact that the most easily-recoverable oil in the world has already been extracted.[27]

Under the peak oil assumption. Gone are the days when barrels of oil could be purchased for less than fifty dollars, and with economic predictions of sustained high oil prices, new revenue models, and hence, sources and extraction methods, open up for petroleum producers that would not have been economically feasible in earlier times.[28] Canada’s oil sands exemplify the difficulty of unconventional oil extraction. It is estimated that the extraction and refining methods in Canada produce up to 60 percent greater emissions than conventional oil, and that the total carbon lifecycle is 15 percent greater, despite lower transportation emissions compared to Middle Eastern oil.[29]

However, within the LCFS is an acknowledgement that petroleum-based fuels are the predominant transportation fuels sold in California today. While the transport fuels market will shift over time, oil will still factor heavily in the future. Given this petroleum-based reality, the LCFS seeks to create market conditions that will incentivize the production of low-carbon fuels to offset the heavy carbon toll of petroleum.

## BIOFUELS AND LAND USE

Biofuels such as corn-based ethanol and soybean-based biodiesel have been produced and subsidized in the United States for many years as an alternative to importing foreign oil.[30] Despite the virtues of growing a “sustainable” domestic energy feedstock, however, environmentalists and alternative energy experts have remained skeptical of biofuels’ virtue as a fuel source.[31] In brief, biofuels such as corn ethanol and soybean biodiesel are food-competing crops that are grown on arable land, which can cause food prices to rise as agricultural products are shifted towards usage as fuel rather than for human consumption.[32] Additionally, the production and refining process of these “first-generation” biofuels requires relatively large amounts of fossil fuel energy, mitigating the total GHG emissions reductions achieved by substituting biofuels for fossil fuels.[33]

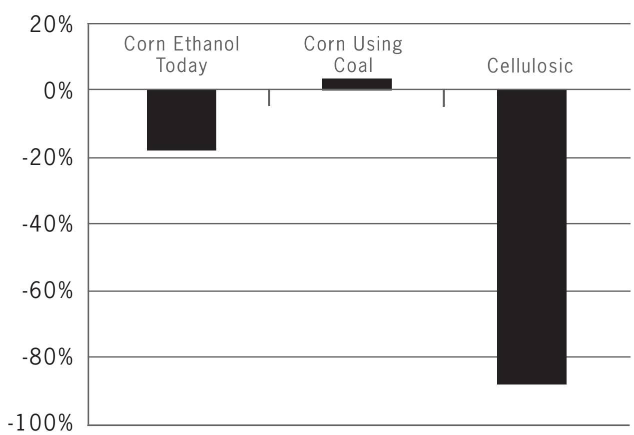
The LCFS is an acknowledgment that biofuels are the most likely near-term candidates to replace fossil fuels in California’s overall fuel supply, due to the research that has already been done on biofuels and the ease of integration with the state’s existing transport fuels infrastructure.[34] Farrell and Sperling anticipate that the enactment of the LCFS and similar state and international legislation will create a vast new market for biofuels, and thus a “gold rush effect” of sorts as agricultural producers shift toward biofuel feedstocks from food production.[35] The LCFS seeks to incorporate the effects of this anticipated land use change in its calculation of the global warming intensity of biofuels, which explains why corn ethanol has a larger carbon intensity value assigned to it (99.40) than gasoline does (95.86) as seen on the chart in the Appendix A. Clearing and plowing previously unused or “virgin” land for growing biofuel crops releases massive amounts of carbon that is sequestered naturally in plants, trees, and soils, thus further mitigating the potential carbon-reduction effects of biofuels.[36]

From the “land use or other indirect effect” calculus springs perhaps the most major source of conflict over the LCFS. Corn ethanol is projected to reach 10 percent of California fuel sales in 2010, and the California petroleum refiners have been assuming that they would be able to increase the blending of ethanol into gasoline

as a method of reaching the LCFS reduction target by 2020.[37] Due to the LCFS attempting to account for the dubious carbon-reduction effects of corn ethanol, however, the oil refineries and corn ethanol producers may not be able to work together to achieve the LCFS target after all. The GHG emission reductions achieved by ethanol compared to gasoline are captured succinctly in the **Figure 3** (below); with "corn using coal" referring to corn ethanol processed using electricity from coal-fired power plants, which in fact creates more GHGs than standard gasoline does. Cellulosic ethanol will be discussed in the next section, but suffice it to say that the potential is great with that fuel.

There is hope for the future of biofuels in the form of "second-generation" feedstocks that are generally defined as non-food competing crops grown on non-arable land.[38] Two examples of these second-generation feedstocks are algae- and jatropha-based biodiesel, and cellulosic ethanol made from both agricultural and municipal waste materials and fast-growing trees and grasses.[39] Second-generation biofuels reduce the pressure on food supplies and agricultural lands as well as reduce the amount of fossil fuel use needed in the production process compared to first-generation biofuels.[40] Commercial development of second-generation biofuels has lagged, due to the increased

**Figure 3: Change in GHGs compared to gasoline**




Source: Farrell et al., "Ethanol Can Contribute to Energy and Environmental Goals." Science, Jan 27, 2006

expense of producing the fuels, as well as the difficulty inherent in "scaling-up" production to the point of commercial viability due to relatively unproven production techniques.[41] Because of these concerns, second-generation biofuels are not projected to become commercially viable until approximately 2015, and then likely only in limited markets.[42]

Biofuels are expected to play a key role in petroleum refiners' eventual compliance with the LCFS carbon reduction targets. However due to the ongoing concerns regarding corn ethanol's carbon lifecycle effects and the current lack of second-generation biofuels, the near-term future remains uncertain for biofuels in California.

# ELECTRIC VEHICLES

Electric-drive vehicles are considered by many environmental and auto enthusiasts to be the most likely replacement for the internal-combustion engine. The advent of the Toyota Prius, Honda Insight, and a range of Lexus, Ford, Nissan, and other models of hybrid-electric vehicles (HEVs) have brought hybrids into the mainstream auto market in America and internationally. HEVs use both electric and petrol motors linked to batteries to propel the car, and include regenerative braking, which uses the energy created during braking to recharge the batteries.[43] Hybrids have been proven to increase fuel efficiency compared to conventional vehicles, although they have been viewed as transitional technologies on the path towards even more efficient vehicles.[44]

The next development in hybrid vehicles is the plug-in hybrid electric vehicle (PHEV) which is driven completely by electricity through overnight charging at home, coupled with the internal combustion engine being used solely to recharge the batteries once on the move.[45] The Chevrolet Volt is an example of this new technology that has received widespread attention, and

it is projected to travel for up to 40 miles using solely electric drive with a total range of up to 700 miles.[46] Due to the fact that PHEVs and their battery-electric vehicle (BEV) counterparts will be drawing upon California's electric supply for their motive force, the LCFS authors included an analysis of the GWI of California's electric supply as a fuel source in the LCFS regulations.

California's electricity mix is a dynamic blend of sources, including coal, hydroelectric, natural gas, nuclear, and a renewable portfolio comprising about 10 percent of the total energy produced in 2006.[47] The authors of the LCFS note that due to demand varying during seasons and during the course of a day, there is a significant amount of unused capacity in the electric grid, especially during off-peak hours.[48] Coal and nuclear power plants are the primary electricity supply sources for California,[49] and as such, the calculation of GWI for electricity from California's average supply mix is rated at 124.10 $gCO_2e$ /MJ, compared to the "marginal electricity mix of natural gas and renewable energy sources," which is calculated at 104.71 $gCO_2e$ / MJ.[50] Again, the electricity GWI figures represent an increase over the gasoline rating of 95.86 $gCO_2e$ /MJ due to the carbon intensity of coal-fired power plants, which are essentially "always on" in California. Due to California's Renewable Portfolio Standard, however, utilities are required to have contracts for 20 percent renewable energy as of 2010, so the GWI figures for electricity from the California grid ought to be appreciably lower in the near term.[51]

With high-profile launches of PHEVs like the Chevy Volt and other electric-drive vehicles to come, the LCFS is designed to pinpoint the inefficiencies (from a GHG production standpoint) of the fuel supply system, including that of California's electrical grid. The GWI figures for electricity reveal that until California reduces its reliance on coal-fired power plants for electricity, electric-drive vehicles will not be as environmentally-friendly as they could be.

## HYDROGEN

Apart from biofuels and electric vehicles, the primary alternative fuel that is seen by the authors of the LCFS as being viable in the future are hydrogen powered fuel cell vehicles (FCVs). Similar to electric vehicles, hydrogen vehicles can operate with a high level of efficiency and zero tailpipe emissions.[52] Also like electricity, hydrogen's GWI measure is one-hundred percent dependent on the method of production used,[53] ranging from an upper bound of 142.20 $gCO_2e$ /MJ for hydrogen reformed from natural gas down to 76.10 $gCO_2e$ /MJ for hydrogen reformed from renewable feedstocks, as noted in Appendix A.

While hydrogen has great potential for reducing the carbon content of transportation fuels, at present the large-scale commercial processes for hydrogen production rely heavily on fossil fuels, primarily natural gas.[54] That said, a technical review of the production processes for hydrogen is beyond the scope of this paper, suffice it to say that the challenges to scaling-up renewable-based production and making it cost-effective are great. Other significant issues with hydrogen are that in order to establish hydrogen as a viable fuel option, expensive and extensive infrastructure changes will need to be made for storing and distributing the fuel; even the most optimistic projections estimate that fewer than 5 percent of all vehicles on US roads will be run on hydrogen by 2025.[55] While hydrogen has a promising future, at this point in 2010, it is difficult to see how hydrogen will aid regulated fuel companies in their quest to meet the LCFS targets by 2020.

## OTHER ALTERNATIVE FUELS

Further alternative fuels that the LCFS regulates are liquefied natural gas and compressed natural gas, although the authors of the LCFS note that natural gas usage is currently miniscule, and that they do not foresee widespread demand for natural gas vehicles due to specialized infrastructure needs and price uncertainty.[56] For that reason, we will not pursue natural gas powered vehicles further in this chapter.

## INDUSTRY RESPONSE TO THE LCFS

## FOSSIL FUEL SUPPLIERS

The LCFS was created with significant petroleum industry input, as firms in the industry apparently realized that California was going to regulate fuel emissions with or without their contributions. Therefore, they decided to "get on board" with the LCFS program.[57] Indeed, Rick Zalesky, a Chevron executive in charge of biofuels and hydrogen, stood next to Governor Arnold Schwarzenegger at the press conference announcing the LCFS in 2007, and spoke favorably about the regulations.[58]

Following the LCFS being given final enactment by the California Office of Administrative Law in January 2010, however, the petroleum and associated industry associations filed a lawsuit attempting to challenge the constitutionality of the LCFS in U.S. District Court in Fresno.[59] The National Petrochemical and Refiners Association, American Trucking Associations, Consumer Energy Alliance, and the Center for North American Energy Security argue that the LCFS "violates the Commerce Clause of the U.S. Constitution by imposing undue and unconstitutional mandates on interstate commerce."[60] News reports indicate that the case has been primarily brought by out-of-state business interests who are concerned about the effect that the LCFS would have on the market for Midwest-produced corn ethanol, Canadian tar sands oil, and domestic shale oil and coal.[61] On June 16, 2010, Judge Lawrence O'Neill of the US District Court for the Eastern District of California denied CARB's motion to dismiss the lawsuit, arguing that

> *…(D)efendants assert that Section 211(c)(4)(B) [of the Clean Air Act] authorizes California to violate the dormant Commerce Clause. Having considered the parties' arguments, amicus curiae briefs and relevant legal authority, this court finds that Section 211(c)(4)(B) provides no express authority for California's LCFS…*[62]

CARB had the option of appealing the ruling to the U.S. Court of Appeals for the 9th Circuit,[63] however as will be seen below, there are further threats to the LCFS' implementation on the horizon.

Two further arguments the groups made against the LCFS are that it would increase fuel costs by $3.7 billion over the next decade in California and that the regulations would drive producers of more carbon-intense petroleum products to sell those products in other states, negating the carbon reduction that the LCFS would achieve within California.[64] The California Air Resources Board claims that the fossil fuel industry's cost figures are overly high, countering that when the LCFS is fully functional in 2020 that Californians will save approximately $11 billion per year compared to current conditions.[65] As for the argument that suppliers will sell their carbon-intense products to other states, that may

well happen. However, 11 Northwestern states are now seeking to adopt the LCFS as a model for their own climate change reduction efforts, so the market for nonconventional oils and corn ethanol may be somewhat reduced in coming years.[66] Examining a similar lawsuit brought by the ethanol industry may shed further light on the LCFS' legal path forward in the next section.

In advance of the November 2, 2010 elections, a coalition of out-of-state energy interests and allied groups, calling themselves the California Jobs Initiative, qualified Proposition 23 for the statewide ballot, which would suspend AB32, and the LCFS, until the state's unemployment rate drops to 5.5% or less for a full year.[67] The election has not occurred as of this writing. However, it is clear that if Proposition 23 were to pass, the result would be a complete halt to California's implementation of AB 32 and associated climate measures, such as the LCFS.

## ALTERNATIVE FUEL SUPPLIERS

In December 2009, The Renewable Fuels Association and Growth Energy, two ethanol industry trade groups, filed suit in US District Court in Fresno arguing (similarly to the case noted above) that the LCFS violates both the Supremacy Clause and the Commerce Clause of the US Constitution.[68] While the previously-noted suit also dealt with the Commerce Clause issue, the Supremacy Clause argument is unique to the ethanol industry's case. In 2007, Congress passed the Energy Independence Security Act (EISA) that mandates that 36 billion gallons of renewable fuels be utilized in the nation's fuel supply by 2022.[69] Pursuant to that law, the ethanol industry's lawsuit argues that the LCFS interferes with the EISA by effectively prohibiting the sale of corn ethanol in California through the indirect land use GWI calculations, and that because Congressional law is the supreme law of the land, the LCFS must give way to the EISA.[70]

Both the petroleum and ethanol industry lawsuits make compelling arguments against the LCFS, and it would appear that the Supremacy Clause argument could well tip the judicial scales in the ethanol industry's favor. However, other experts do not necessarily agree with the industry's argument. Noting that this is one of the first US cases concerning "green federalism," California environmental lawyer Mackinnon Lawrence argues that to the extent the LCFS was crafted in order to protect the health and safety of California's citizens, the courts will be loath to overrule that state prerogative.[71] To the extent that both lawsuits are based at least in part on the Commerce Clause, and Lawrence's argument holds up, it is possible that neither lawsuit will be successful in overturning the LCFS. In any case, due to the federalist principles underlying these two cases, it is clear that the environmental and energy communities will be watching closely.

A further challenge to the LCFS was registered by researchers at Purdue University, who released a report challenging the indirect land use penalties employed by CARB in evaluating biofuels, arguing that the CARB calculations overstate the penalties by a factor of two.[72] In response, CARB Executive Officer James Goldstene, in the Low Carbon Fuel Standard Regulation Update of May 19, 2010, noted that CARB is reviewing the Purdue research and has involved the report's authors in the ILUC Expert Workgroup convened to evaluate the ILUC parameters.[73] Goldstene noted that the Purdue value findings were within the range of results that CARB found in running sensitivity analyses, and thus should not be perceived as discounting the original CARB findings.[74]

# THE END-USER'S EXPERIENCE OF THE LCFS

## THE CONSUMER'S EXPERIENCE

When California consumers shop for personal vehicles in the next decade, it is intended that under the LCFS they will have not only options about what color or trim levels they want, but integral to the auto-buying process will be what type of fuel they want their car to utilize. The LCFS authors note that there is an intriguing potential synchronization to be had with AB1493, the "Pavley bill" mandating that passenger autos achieve a 30 percent reduction in GHGs by 2016.[75] Much of the problem with alternative fuels and alternative fuel vehicles is that the economics reveal a quintessential "chicken and egg" scenario; automakers will not build non-petroleum vehicles until there is a fuel supply, and fuel suppliers will not invest in clean technologies until there are vehicles to fuel. The LCFS seeks to treat one aspect of this balance by working off of a "demand pull" model for alternative fuel technologies that have proven to be viable from a technical standpoint, yet have not been economically viable in the petroleum-dominated fuels market.[76]

According to the LCFS authors' projections, the cars we will drive in 2020 will be quite varied in terms of fuel consumption, but that even with large electric vehicle market share it is unlikely that the LCFS GHG reduction target would be reached by 2020.[77] Seeing that plug-in hybrid electric vehicles are the next near-term technology to reach California streets, and full battery electric vehicles such as the Tesla Roadster are already on the market, electric vehicles appear to be the next wave. The biofuels market is still relatively untapped beyond the ubiquitous corn ethanol, however, and how the indirect land use effect calculations will alter the biofuels market is still unclear at this point. As was discussed, hydrogen appears to be too far in the future to have an effect on the 2020 target. Thus, it would appear that California consumers will still be dealing with the same primarily liquid-fuels market in place currently, with the likely addition of electric vehicles as well.

## PRICING CHANGES

Regulatory agencies have tinkered with fuel regulations numerous times over the years, perhaps most infamously with the incorporation of the fuel additive MTBE in gasoline as a part of the 1990 Clean Air Act Amendments.[78] MTBE was a fuel additive that increased the oxygen levels in gasoline, and therefore led to cleaner combustion and fewer emissions. However, MTBE also dissolves in groundwater and remains there for long periods of time, so that when MTBE was detected in drinking water across California, the public and political backlash against the oil companies was strong.[79] When discussing the LCFS, the Western States Petroleum Association employs the ill-fated MTBE regulations as a cautionary tale against moving too quickly with new fuel regulations.[80]

Aside from the prospect of causing unintended consequences, one of the more persuasive arguments the fossil fuel and corn ethanol industries have made against the LCFS is that it would raise fuel prices significantly in California. Additionally, there are concerns that the imposition of the LCFS on oil refineries in California will drive the refineries to close due to increased operating costs, which would further increase prices for consumers.[81] Since 1996, when California adopted new regulations for cleaner-burning gasoline, the price of gas has increased, while the number of refineries producing the California

blend of gasoline has decreased from 32 in the mid-1980s to 14 today.[82] The decrease is in part due to the new gasoline formula.[83] Thus, California's fuel supply is prone to more price fluctuations compared to the rest of the country due to tight supply. Both the public and industry are thus concerned that the LCFS could tip the balance towards further price increases.

In response to those concerns, members of the Air Resources Board argue that California's fuel dependence on one source of transportation fuel and a dwindling number of oil refineries is exactly the reason why the LCFS is needed. By diversifying the state's transport fuel options, the LCFS, when fully implemented in 2020, should protect against future price spikes by lessening California's dependence on petroleum.[84] Furthermore, as noted earlier, the California Air Resources Board claims that California consumers will save $11 billion a year by reducing the amount of petroleum used in the state, and that alternative fuels will become cheaper as the market for them is opened up in California.[85] At this point, the one thing that is clear is that fuel prices are expected to rise in the initial phases of LCFS implementation as the oil refiners seek to comply with the emissions reduction targets. Beyond those initial estimates overall costs due to the LCFS are unclear.

## CONCLUSION

There is an element of faith in technology and entrepreneurship at work in the Low Carbon Fuel Standard, a trust that—if given the right conditions—Californian and other entrepreneurs will produce the alternative fuels of tomorrow in the near term. Moreover, there is also a faith in markets that underlies the LCFS and an implicit admission that the command-and-control models of environmental regulation of the past will not work in these times of rapidly shifting technology and economic uncertainty. In contrast to previous environmental regulations, CARB is required to be especially responsive in administering the LCFS, and indeed, expert panels and workgroups are currently still working out details of GWI figures and how to craft more efficient and accurate indirect land use change calculations.

While controversy over the land use change provisions of the regulations will inevitably continue to play out in the courts and among the informed publics, a larger question that can be raised is whether the LCFS privileges environmental concerns over domestic energy security. By taking into account the full carbon lifecycle analysis of domestically-produced corn ethanol and Canadian and American nonconventional oil, the authors of the LCFS argue that they are simply pricing the realities of modern energy production costs. However, by putting these North American fuels at a disadvantage, the LCFS undoubtedly will force California's petroleum to be increasingly shipped from outside of North America, at least in the short term.

While it is premature to declare the LCFS either an unmitigated success or failure at this point in time, it is apparent that the regulatory model put forth by Dan Sperling and Alex Farrell is indeed innovative and could herald the emergence of a new paradigm for energy regulatory policy. The authors' pursuit of industry "buy-in" from the outset, coupled with clear goals and methods to achieve those goals appears to have given the LCFS a more sustainable and less economically intrusive regulatory regime. While there will undoubtedly be price increases that result from the LCFS regime, it is difficult to model a situation where price increases would not occur as the era of cheap oil moves inevitably towards closure. The Low Carbon Fuel Standard provides the platform upon which the new energy future can be built, so that despite oil losing some of its massive share of the transportation fuels market, the technologies that will replace oil will become increasingly competitive over time.

## CARBON INTENSITY LOOKUP TABLE FOR GASOLINE AND FUELS THAT SUBSTITUTE FOR GASOLINE

| Fuel | Pathway Description | Carbon Intensity Values ($gCO_2e/MJ$) | | |
|---|---|---|---|---|
| | | Direct Emissions | Land Use or Other Indirect Effect | Total |
| Gasoline | CARBOB – based on the average crude oil delivered to California refineries and average California refinery efficiencies | 95.86 | 0 | 95.86 |
| Ethanol from Corn | Midwest average; 80% Dry Mill; 20% Wet Mill; Dry DGS | 69.40 | 30 | 99.40 |
| | California average; 80% Midwest Average; 20% California; Dry Mill; Wet DGS; NG | 65.66 | 30 | 95.66 |
| | California; Dry Mill; Wet DGS; NG | 50.70 | 30 | 80.70 |
| | Midwest; Dry Mill; Dry DGS, NG | 68.40 | 30 | 98.40 |
| | Midwest; Wet Mill, 60% NG, 40% coal | 75.10 | 30 | 105.10 |
| | Midwest; Wet Mill, 100% NG | 64.52 | 30 | 94.52 |
| | Midwest; Wet Mill, 100% coal | 90.99 | 30 | 120.99 |
| | Midwest; Dry Mill; Wet, DGS | 60.10 | 30 | 90.10 |
| | California; Dry Mill; Dry DGS, NG | 58.90 | 30 | 88.90 |
| | Midwest; Dry Mill; Dry DGS; 80% NG; 20% Biomass | 63.60 | 30 | 93.60 |
| | Midwest; Dry Mill; Wet DGS; 80% NG; 20% Biomass | 56.80 | 30 | 86.80 |
| Ethanol from Sugarcane | California; Dry Mill; Dry DGS; 80% NG; 20% Biomass | 54.20 | 30 | 84.20 |
| | California; Dry Mill; Wet DGS; 80% NG; 20% Biomass | 47.44 | 30 | 77.44 |
| | Brazilian sugarcane using average production processes | 27.40 | 46 | 73.40 |
| | Brazilian sugarcane with average production process, mechanized harvesting and electricity co-product credit | 12.40 | 46 | 58.40 |
| Compressed Natural Gas | Brazilian sugarcane with average production process and electricity co-product credit | 20.40 | 46 | 66.40 |
| | California NG via pipeline; compressed in CA | 67.70 | 0 | 67.70 |
| | North American NG delivered via pipeline; compressed in CA | 68.00 | 0 | 68.00 |
| Liquefied Natural Gas | Landfill gas (bio-methane) cleaned up to pipeline quality NG; compressed in CA | 11.26 | 0 | 11.26 |
| | Dairy Digester Biogas to CNG | 13.45 | 0 | 13.45 |
| | North American NG delivered via pipeline; liquefied in CA using liquefaction with 80% efficiency | 83.13 | 0 | 83.13 |
| | North American NG delivered via pipeline; liquefied in CA using liquefaction with 90% efficiency | 72.38 | 0 | 72.38 |
| | Overseas-sourced LNG delivered as LNG to Baja; re-gasified then re-liquefied in CA using liquefaction with 80% efficiency | 93.37 | 0 | 93.37 |
| | Overseas-sourced LNG delivered as LNG to CA; re-gasified then re-liquefied in CA using liquefaction with 90% efficiency | 82.62 | 0 | 82.62 |
| | Overseas-sourced LNG delivered as LNG to CA; no re-gasification or re-liquefaction in CA | 77.50 | 0 | 77.50 |
| | Landfill Gas (bio-methane) to LNG liquefied in CA using liquefaction with 80% efficiency | 26.31 | 0 | 26.31 |
| | Landfill Gas (bio-methane) to LNG liquefied in CA using liquefaction with 90% efficiency | 15.56 | 0 | 15.56 |
| | Dairy Digester Biogas to LNG liquefied in CA using liquefaction with 80% efficiency | 28.53 | 0 | 28.53 |
| | Dairy Digester Biogas to LNG liquefied in CA using liquefaction with 90% efficiency | 17.78 | 0 | 17.78 |
| Electricity | California average electricity mix | 124.10 | 0 | 124.10 |
| | California marginal electricity mix of natural gas and renewable energy sources | 104.71 | 0 | 104.71 |
| Hydrogen | Compressed H2 from central reforming of NG (includes liquefaction and re-gasification steps) | 142.20 | 0 | 142.20 |
| | Liquid H2 from central reforming of NG | 133.00 | 0 | 133.00 |
| | Compressed H2 from central reforming of NG (no liquefaction and re-gasification steps) | 98.80 | 0 | 98.80 |
| | Compressed H2 from on-site reforming of NG | 98.30 | 0 | 98.30 |
| | Hydrogen Compressed H2 from on-site reforming with renewable feedstocks | 76.10 | 0 | 76.10 |

# CARBON INTENSITY LOOKUP TABLE FOR DIESEL AND FUELS THAT SUBSTITUTE FOR DIESEL

| Fuel | Pathway Description | Carbon Intensity Values ($gCO_2e/MJ$) Direct Emissions | Land Use or Other Indirect Effect | Total |
|---|---|---|---|---|
| **Diesel** | ULSD – based on the average crude oil delivered to California refineries and average California refinery efficiencies | 94.71 | 0 | 94.71 |
| **Bio Diesel** | Conversion of waste oils (Used Cooking Oil) to biodiesel (fatty acid methyl esters -FAME) where “cooking” is required | 15.84 | 0 | 15.84 |
| | Conversion of waste oils (Used Cooking Oil) to biodiesel (fatty acid methyl esters -FAME) where “cooking” is not required | 11.76 | 0 | 11.76 |
| | Biodiesel Conversion of Midwest soybeans to biodiesel (fatty acid methyl esters –FAME) | 21.25 | 62 | 83.25 |
| **Renewable Diesel** | Conversion of tallow to renewable diesel using higher energy use for rendering | 39.33 | 0 | 39.33 |
| | Conversion of tallow to renewable diesel using lower energy use for rendering | 19.65 | 0 | 19.65 |
| | Conversion of Midwest soybeans to renewable diesel | 20.16 | 62 | 82.16 |
| **Compressed Natural Gas** | California NG via pipeline; compressed in CA | 67.70 | 0 | 67.70 |
| | North American NG delivered via pipeline; compressed in CA | 68.00 | 0 | 68.00 |
| | Landfill gas (bio-methane) cleaned up to pipeline quality NG; compressed in CA | 11.26 | 0 | 11.26 |
| | Dairy Digester Biogas to CNG | 13.45 | 0 | 13.45 |
| **Liquefied Natural Gas** | North American NG delivered via pipeline; liquefied in CA using liquefaction with 80% efficiency | 83.13 | 0 | 83.13 |
| | North American NG delivered via pipeline; liquefied in CA using liquefaction with 90% efficiency | 72.38 | 0 | 72.38 |
| | Overseas-sourced LNG delivered as LNG to Baja; re-gasified then re-liquefied in CA using liquefaction with 80% efficiency | 93.37 | 0 | 93.37 |
| | Overseas-sourced LNG delivered as LNG to CA; re-gasified then re-liquefied in CA using liquefaction with 90% efficiency | 82.62 | 0 | 82.62 |
| | Overseas-sourced LNG delivered as LNG to CA; no re-gasification or re-liquefaction in CA | 77.50 | 0 | 77.50 |
| | Landfill Gas (bio-methane) to LNG liquefied in CA using liquefaction with 80% efficiency | 26.31 | 0 | 26.31 |
| | Landfill Gas (bio-methane) to LNG liquefied in CA using liquefaction with 90% efficiency | 15.56 | 0 | 15.56 |
| | Dairy Digester Biogas to LNG liquefied in CA using liquefaction with 80% efficiency | 28.53 | 0 | 28.53 |
| | Dairy Digester Biogas to LNG liquefied in CA using liquefaction with 90% efficiency | 17.78 | 0 | 17.78 |
| **Electricity** | California average electricity mix | 124.10 | 0 | 124.10 |
| | California marginal electricity mix of natural gas and renewable energy sources | 104.71 | 0 | 104. 71 |
| **Hydrogen** | Compressed H2 from central reforming of NG (includes liquefaction and re-gasification steps) | 142.20 | 0 | 142.20 |
| | Liquid H2 from central reforming of NG | 133.00 | 0 | 133.00 |
| | Compressed H2 from central reforming of NG (no liquefaction and re-gasification steps) | 98.80 | 0 | 98.80 |
| | Compressed H2 from on-site reforming of NG | 98.30 | 0 | 98.30 |
| | Hydrogen Compressed H2 from on-site reforming with renewable feedstocks | 76.10 | 0 | 76.10 |

NOTE: Authority cited: Sections 38510, 8560, 38560.5, 38571, 38580, 39600, 39601, 41510, 41511, Health and Safety Code; and Western Oil and Gas Ass’n v. Orange County Air Pollution Control District, 14 Cal.3rd 411, 121 Cal.Rptr. 249 (1975). Reference cited: Sections 38501, 38510, 38560, 38560.5, 38571, 38580, 39000, 39001, 39002, 39003, 39515, 39516, 41510, 41511, Health and Safety Code; and Western Oil and Gas Ass’n v. Orange County Air Pollution Control District, 14 Cal.3rd 411, 121 Cal.Rptr.249 (1975).

# APPENDIX B: GLOSSARY

**AB 32** = Global Warming Solutions Act

**CARB** = California Air Resources Board

**CARBOB** = California reformulated gasoline blendstock for oxygenate blending

**CNG** = Compressed natural gas

**DGS** = Distillers dried grains

**EISA** = Energy Independence Security Act

**FAME** = Fatty acid methyl esters

**GHS** = Greenhouse gas

**gCO¬¬2e/MJ** = Grams of carbon dioxide equivalent per megajoule of fuel delivery

**GWI** = Global warming intensity

**HEV** = Hybrid electric vehicle

**LCA** = Lifecycle analysis (of carbon)

**LCFS** = Low carbon fuel standard

**LNG** = Liquified natural gas

**MTBE** = Methyl tert-butyl ether

**NG** = Natural gas

**PHEV** = Plug-in hybrid electric vehicle

**VMT** = Vehicle miles traveled

**ZEV** = Zero-emission vehicle

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# END NOTES

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4 Gordon, 195-6.

5 David R. Baker, *San Francisco Chronicle*, comment posted on April 22, 2009.

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7 Gordon, 194.

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12 Executive Order S-01-07, Section 4.

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14 See Appendix.

15 Farrell, 50.

16 California Air Resources Board 2009, VI-3.

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19 Ibid., 52.

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21 David Crane and Brian Prusnek, "The Role of a Low Carbon Fuel Standard in Reducing Greenhouse Gas Emissions and Protecting our Economy," comment posted on January 8, 2007.

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23 David Crane and Brian Prusnek, "The Role of a Low Carbon Fuel Standard in Reducing Greenhouse Gas Emissions and Protecting our Economy," comment posted on January 8, 2007.

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25 Gordon, 195.

26 Farrell, 2.

27 Metz, 50.

28 Ibid., 51.

29 Gordon, 126.

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32 Metz, 100.

33 Greene, 209.

34 Sperling, 39.

35 Farrell, 63.

**36** Metz, 100.

**37** Dale Kasler, Sacramento Bee, comment posted on April 25, 2009.

**38** Metz, 101.

**39** Gordon, 99.

**40** Metz, 101.

**41** Sims et al, 33.

**42** Ibid., 33.

**43** Metz, 98.

**44** De Haan et al, 2006.

**45** Metz, 99.

**46** Ibid., 99.

**47** Sperling, 68.

**48** Ibid., 68.

**49** Ibid., 69.

**50** See Appendix A.

**51** Farrell, 101.

**52** Farrell, 70.

**53** Sperling, 44.

**54** Farrell, 70.

**55** Ibid., 71.

**56** Sperling., 101.

**57** Gordon, 196.

**58** Ibid., 196.

**59** Nick Snow, Oil & Gas Journal, comment posted on February 4, 2010.

**60** Ibid.

**61** Ibid.

**62** National Association of Convenience Stores, comment posted on June 28, 2010.

**63** Ibid.

**64** Dale Kasler, Sacramento Bee, comment posted on February 3, 2010.

**65** Dale Kasler, Sacramento Bee, comment posted on April 25, 2009.

**66** Mackinnon Lawrence, Biofuels Digest, comment posted on February 3, 2010.

**67** "General Fact Sheet," No on 23,

**68** Jim Lane, Biofuels Digest, comment posted on December 28, 2009.

**69** Mackinnon Lawrence, Biofuels Digest, comment posted on February 3, 2010.

**70** Jim Lane, Biofuels Digest, comment posted on December 28, 2009.

**71** Mackinnon Lawrence, Biofuels Digest, comment posted on February 3, 2010.

**72** Renewable Fuels Association, comment posted on May 13, 2010.

**73** Executive Officer James N. Goldstene to Chairman Mary D. Nichols, May 19, 2010, Air Resources Board, Sacramento, CA.

**74** Ibid.

**75** Farrell, 69.

**76** Ibid., 13-14.

**77** Sperling, 138.

**78** Gordon, 84.

**79** Ibid., 84.

**80** WSPA, “Low Carbon Fuel Standard”.

**81** WSPA, “Energy Alert, January 2010”.

**82** Ibid.

**83** David R. Baker, San Francisco Chronicle, comment posted on April 22, 2009.

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5

# POLICY OPTIONS FOR UNIVERSITY OF CALIFORNIA BUDGETING


## CHARLES E. YOUNG

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For most of the time since the end of World War II, California has generally been recognized as the national leader in a large number of important categories. Of course, the growth in the state's population has led the national growth rate, primarily due to the in-migration from other states, and, indeed, around the world. Its economy was the envy of all, growing to become the 6th or 7th largest in the world. Employment was high and it served as the home for many large and growing businesses and industries.

The entertainment industry settled in Hollywood early on and that provided a notoriety that attracted additional immigrants and related business opportunities. Its vast and fertile agricultural areas produced a wealth and variety of products not known elsewhere in the world—citrus in the Los Angeles Basin and the Inland Empire, desert crops in the Coachella Valley, wine in the Napa, Sonoma and Mendocino Valleys, and, of course the greatest agricultural region of them all, the great Central Valleys of San Joaquin and Sacramento.

The war and post war-years saw several additions to those early achievements. Much of the nation's defense, space and aircraft industry found its home in California. The high tech industry, first in computer technology and then in bio-medical expertise, was born and flourished in the state. California's system of higher education, especially following the adoption of the Master Plan for Higher Education, 50 years ago, with its tripartite system was looked to as a model to be followed not only across the U.S. the country but around the world as well.

There are clearly many reasons for California's achieving this level of preeminence: its geography and climate, the openness to new people and new ideas, the availability of land and the opportunities provided by its growing industrial and agricultural base. Even its political system, non-partisan in comparison to those in the states from which the new citizens had

come, was welcoming to new arrivals, many of whom played major roles in the politics to the benefit of their adopted state.

A very important ingredient in the creation of this model state of affairs was the role played by higher education, both public and private, but especially the University of California (UC). California came out of World War II with a number of blessings. Among them was the "Rainy Day Fund" which had been amassed during WWII by Governors Culbert Olson and Earl Warren. A second was the recognition by its political leaders of the role that had been played by the University of California, primarily the Berkeley campus, in the prosecution of WWII and the creation of California's war related industry, which kick-started the early and strong postwar recovery of the state's economy.

## THE UNIVERSITY OF CALIFORNIA

The interaction of these two factors created the financial and political basis for a growth in the University, which, when further fueled by the GI Bill, resulted in dramatic increase in the UC system between 1945 and 1960. In a short period, the existing general campuses, Berkeley and UCLA, as well as the medical campus in San Francisco, grew dramatically in size, physical and financial resources and quality. Santa Barbara State College was transformed into a campus of the University. Two new general educational programs were built upon the great general agricultural base at the Davis and the Citrus Experiment Station at Riverside. By 1960, three new general campuses were approved--UC Irvine and UC Santa Cruz—rising from sprawling farmland and redwood forest respectively—and UC San Diego, building upon the world-renowned Scripps Institution of Oceanography.

The University's role in California's development was not new. Its graduates had long filled the ranks of the professional scientific and business sectors of California's economy. As previously noted, the great California agricultural enterprise owed much of its success to the faculty, researchers, and graduates of the agricultural programs at Davis, Berkeley, Riverside, and UCLA. The military research and manufacturing enterprise, developed so quickly as World War II enveloped the nation, was peopled by its graduates and supported by its research capability.

But the half century following World War II saw something different in kind. UC was widely recognized as the yeast enabling the state's other remarkable resources to rise to the levels which propelled California forward. Through the crises of the Civil Rights Movement, the Vietnam War and the resulting era of student unrest, erupting from the Free Speech Movement at Berkeley, the University remained well-supported by California. It grew in size, quality, and its ability to serve the state. During the span of 22 years, three of the older campuses, UCLA, Davis, and Santa Barbara, as well as two of the new, San Diego and Irvine, were admitted to the Association of American Universities, alongside Berkeley, placing all six within the top 60 research universities in the nation as recognized by their peers.

Within a quarter century after the end of World War II (1945-1970), largely because of the support and investment it received from the State, the University of California had changed from two modest-size general campuses (Berkeley and Los Angeles) and the medical campus in San Francisco (UCSF), to a system of eight general campuses. These campuses provided the full span of undergraduate educational programs, a wide variety of high-quality graduate academic programs, and a growing array of nationally recognized professional schools, plus a ninth specialized campus (UCSF). UCSF and the other medical schools comprised an eminent group of medically-related professional institutions with an international reputation for biomedical research.

For its part, California was at the pinnacle of its success—its economy strong and growing, along with its population, beginning to take a leadership in national politics, with one of its native sons (Richard Nixon) occupying the Oval Office.

## CLOUDS ON THE HORIZON

Through the late 1970s and into the mid-1980s, the synergism which had been created continued, for the most part, to work its magic, propelling both the University and the state to even greater levels. Although there were ups and downs in the levels of support for UC, these were generally the result of temporary aberrations. The slope of the curve was generally upward.

Although the percentage of the University's total operating expenditures which was funded by the State, steadily declined over that period (from 32% in 1976 to 27% in 1986) this drop was in large part due to growth in the denominator. There was a steady increase in the amount of UC funding from other-than-state sources. UC received private support, federal contracts and grants, medical centers' revenues, and income from operations such as parking and residence halls. The core funding—the money needed for general educational and related administrative expenses—continued to come primarily from the State.

However, beginning with the adoption of the UC and State budgets of 1970 (both created under the strong hand of then-Governor Ronald Reagan), the concept of a tuition-free University of California—a concept that had been one of the premises of the Master Plan adopted just ten years earlier—was dramatically changed. In the ensuing forty years from 1970 to 2010, the so-called "education fee" became, in fact, tuition. It steadily increased at a rate that outpaced the growth of personal income in California during that period. The burden of funding the core undergraduate and graduate educational programs at the University's campuses is now shared responsibility between the State and the enrolled students. Indeed, with the cuts of the past few years and the fee increases imposed to partially offset those losses, student fees account for about $4 out of every $10 of core support. In fiscal 2010, the income from tuition and fees was greater than the amount provided by the state.

## PROPOSITION 13

Two other seminal events brought difficulty for both the State and its University. One was the passage of two propositions a decade apart, Proposition 13 in 1978 and Proposition 98 in 1988. The first of these is perhaps the most famous or infamous of the many propositions that have been adopted by California voters since the creation of the direct democracy process under Governor Hiram Johnson in 1911. Prop 13 contained a number of provisions. Of these, two were particularly impactful on California's subsequent fall from grace.

The most prominent provision of that proposition amended the State constitution to roll back property taxes to their level three years earlier, limited them to 1% of assessed valuation, and restricted increases to the level of inflation, but in no instance more than 2% of the prior year's value. A second (and at the time largely unnoticed) provision of Prop 13 required a two thirds majority in both houses of the legislature for the passage of any measure which increased tax rates or amounts of revenue collected.

While the limits placed on the property tax did not directly affect the state budget or its programs, the subsequent indirect effect was enormous. The effect of Prop 13 on local governments and districts, especially public school and community college districts,

was such that the State chose to bail them out by temporarily "State-izing" them. Sacramento could handle the bailout initially because at that particular moment California had an unusually large General Fund reserve. But his action led to a permanent systemic change. Programs previously supported by local revenues became dependent on State support for their basic operations. This sea change resulted in a substantial reduction in the level of support for traditionally state-funded programs—especially UC and the State University System.

The second important provision of Prop 13, requiring a two thirds majority in both houses for the allocation of funds or increases in revenue, guarantees that the budgetary process will be controlled by the minority. Minority control has resulted in increasingly bitter budgetary battles in which it is extremely difficult, if not impossible, to increase taxes to deal with fiscal crises. That means budget cutting in a depressed or stagnant economy is the only possible solution. The annual budget is now routinely adopted many weeks, even months, after the date required by law, occurring only when the majority finally concedes to the minority.

In addition to guaranteeing budgets which fall short of meeting the needs of the State, this phenomenon reduces the incentive for cross-aisle cooperation (already badly compromised by the existence of "safe" districts created by the legislative redistricting process). The minority knows that it will eventually accomplish what it wishes without the necessity of compromise.

## PROPOSITION 98

The second initiative which has impacted the ability of the State to provide for funds for UC and to higher education generally is Proposition 98, adopted by the voters ten years after the passage of Prop 13. It requires through a set of formulas that about $4 out of $10—and sometimes more—of the State's General Fund revenue be allocated to support K-14 education. While providing some differences for stagnant growth and declining revenue scenarios, the result, in all cases, is a further restriction on the amount of funds which can be allocated to support UC and other programs whose budgets are not tied to specific funding or mandated appropriations. Indeed (as will be spelled out in more detail in a subsequent section) during the recovery period ahead of us, the mandated percentage allocated will undoubtedly increase to an even higher level.[1]

## THE CURRENT REALITY

These and other factors have created a situation in California which is far different from the rosy picture which characterized the fifty years following the end of World War II. The nation, indeed the world, has been mired in a recession, followed by what is at best an extremely slow recovery. But the difficulties facing California now and in the foreseeable future are beyond those of most, if not all, of its sister states. These difficulties are:

- Deficit funding has been the rule for several years. Budget shortfalls have run into many billions of dollars;
- Unemployment reached approximately 12% by 2010, one of the highest in the nation;
- All state services have been drastically cut; state employees have had salary cuts and/or were placed on mandatory unpaid furloughs;
- Health care, education and all social services have been drastically reduced—even local police and fire protection has not been immune from the budgetary axe as the state's fiscal problem cascaded down to cities and counties.

In short, the picture for the immediate future looks as bleak as the present and the immediate past.

The problems facing the State have also severely affected the University of California. While the levels of support in the first 40 years following WWII had their ups and downs, UC's share of the total state budget has declined rather steadily over the past two decades—from 5% in the late nineties to approximately 3% in 2009-10. These reductions have been especially severe during the past decade, culminating in sharp reductions in the past year. In rough terms, state support of UC's average expenditures per student dropped by about 22 percent between 2007-08 and 2008-09 representing reduction in total state support from approximately $3.3 billion to $2.6 billion in that single year. [2]

## POLICY OPTIONS FOR FUNDING UC'S RECOVERY

If UC has in the past been an engine of propelling the growth of California's economy, it would appear to be wise policy to place a high priority on repairing the damage which has been done to it, and will continued to weaken its ability to serve its students and the people of the State and nation. While most observers acknowledge that this is a desired goal, there is little agreement on how best to achieve it. Setting aside the limited numbers who would opt for the status quo, there are three logical options to consider:

- Return to the *status quo ante*;
- Privatization; and,
- A hybrid approach

## *STATUS QUO ANTE* OPTION:

The first of these options is the most broadly argued proposal. Regents, trustees, presidents, chancellors, alumni and students have testified, editorialized, lobbied, and demonstrated for increases in the funds allocated to UC and the State University System. They want increases which would over time return the State's appropriation to levels comparable to when the state's economy was at its peak in the 2000s—or even more. To be successful, this approach would require that the executive and legislative branches of state government to be convinced that:

- The revenues flowing to the General Fund of the State must be increased to a level which would provide sufficient funds to eliminate current deficits, provide for the other high priority needs of the State, and return the level of UC budget appropriations to that which existed at some earlier target date; or,

- UC be provided as large a proportion of funds available from current General Fund levels as would be required to return its public funding to the earlier target date, regardless of the impact of that action on other State-supported services (e.g., health, safety, schools and social services).

The amount of additional funding which would be required under either of those scenarios (by an increase in General Fund revenues or reallocations of currently available General Fund sources) would be the same. If the target date were set, say, at fiscal year 1999-00, just accounting for inflation would require a boost in the UC budget of about $1 billion. Unfunded enrollment growth would add to that figure, as would a variety of other needs, including the necessity to bring the currently underfunded University

Retirement System (UCRS) back into a fully funded position. The amount needed to meet UC's core needs during next decade has been estimated by UC's Office of the President at about $5 billion—almost double the total funding now provided.[3]

Whichever of the possible methodologies for meeting the *status quo ante* option were used, this is an enormous amount to expect the state to provide. Under those circumstances, why is this approach so widely supported?

Many of those who argue for the return to the *status quo ante* apparently assume that the cuts absorbed by UC, CSU, K-14 and other vital services have been caused by reduced revenues coming as a result of the effects of the recession, and that, therefore, with the recovery, funds will be available to replace these cuts. However, the state faces a large structural deficit, the combined result of the factors that have been described above (Props 13 and 98, etc.) compounded by state initiation of other social programs. These social programs were initiated on the assumption that revenues would continue, as they had for most of the previous 50 years, to grow at a predictable rate. Unfortunately, California's current tax structure, depending primarily on a highly progressive income tax with a high maximum rate has resulted in a highly erratic revenue stream.[4] And with the end of the Cold War and the growing antipathy to taxation, the rapid federally-funded growth that once characterized the state is unlikely to resume.

This phenomenon, taken together with the requirements of Prop 98 (as amended in 1990) which require that cuts to the previous levels of funding for K-14 be made up in the following years by disproportionate percentage increases, has created a no-win situation for both UC and the State. Since the state has squeezed the K-14 budget during the Great Recession, funding is likely to be diverted to refunding that segment as revenues increase.[5]

This situation rules out returning to the *status quo ante* through reallocating revenue growth due to economic recovery. It also suggests that increases in state taxes, if that route were followed, would also tend to be eaten up by K-14. So, even if it were possible to get over the maze of hurdles necessary to achieve a tax increase sufficient to substantially increase general fund revenues (which for the reasons set forth in the previous section would not be likely), the revenue increase scenario would not provide major assistance to UC.

## PRIVATIZATION

This potential option is one not often publicly advocated. In its pure form it would mean that the University of California would be turned into a private university. It is inconceivable that this would work for the entire University. Some of the campuses of UC (UC Berkeley, UCLA, UCSF and perhaps UC San Diego and UC Davis) might be able to make such a transition successfully over a reasonable period of time, with declining state support continuing during the transitional period. What would be the positive and negative outcomes of such a change?

The privatization of these four campuses would provide savings something like $1.5 billion based on the State funding provided to those campuses in 2009-10. If these campuses were to become "independent," additional State resources now funding the Office of the President might also be freed up on a *pro rata* basis, perhaps something on the order $200 million, raising the total $1.7 billion—not an inconsequential sum.

There are at least a few *potential* advantages to UC related to this scenario:

- Some or all of the funds saved could be used to make up the deficits at the other campuses created by recent cuts as well as under funding of workload they have assumed.

- A number of restraints and problematic policies which come attached with the State's largess would be removed, allowing the campuses to operate more efficiently, to increase overhead funding from governmental contract and grant sources and increase the level of private giving.

Those benefits, however, would come at substantial costs to the privatized campuses and to UC as a whole. The privatized campuses would not only have to replace the State funds in their current budgets, but also to cover the cuts they have received in the past few years. In addition, they would have to make up for the under funding which has been eating away at their ability to provide the quality of education and research expected of them.

Also, it is not clear how these campuses (or UC on their behalf) would raise the funds for capital outlay which in recent years have come either from State General Obligation bonds or lease revenue bonds. Presumably the newly privatized campuses (or the Regents) would be able to issue the bonds, but this would be a complicated affair. What bond ratings would the newly-privatized campuses receive?

The obvious sources on which the privatizing campuses would have to call to meet these demands for funding would be:

- Increased tuition, perhaps by a combination of across the board increases and differential fees for undergraduates similar to those which have been utilized for some time in the several professional schools;

- Increased overhead from governmental and private contracts and grants;

- Increased private giving totals, together with a shift to a greater proportion of gifts being unrestricted;

- Increased income from non-resident tuition, to be achieved by lifting the cap on the number of non-residents;

- Increased allocations to core funding from service enterprises, and self-sustaining activities such as, for example, executive MBA programs in other professional schools and, even perhaps, in basic undergraduate programs.

Even with these changes and the relaxation or elimination of state imposed restrictions on other options, the sources available to the privatizing campuses under this scenario would likely be insufficient to meet the needs required under a full privatization scheme. Furthermore, a change of that magnitude would likely so modify the character of those campuses involved as to substantially reduce their contributions to the people and State of California which are even more needed now than in the past.

For all of the reasons cited as well as the political and legal difficulties such a move would generate, pure privatization (even if undertaken only be a few of the campuses) would not seem to be a viable option for funding UC.

## A HYBRID OPTION— MODIFIED SELF-SUFFICIENCY

There is, however, a scenario which, while retaining some of the elements of the past partnership between sate and university, might be implemented without unrealistic costs to the State or UC and still allow for the continuing academic health of the university. This option could be exercised by UC as a whole, by several of the campuses operating through UC, or by several campuses (presumably the same ones as discussed

under the “privatization” option) becoming quasi-independent of the current system. It could even be exercised, with approval of campus and UC officials, by schools, colleges or other intra-campus organizations.

UCLA’s Anderson School of Management has developed a proposal, supported by UCLA’s chancellor (but at this writing not yet considered by UC president Yudof or the Board of Regents). It would trade the small amount of state funds still included in its budget for greater flexibility in a variety of areas. Judy Olian, dean of the Anderson School, has referred to this proposed change as a move toward “self sufficiency” rather than “privatization” (a term which has caused difficulty both at UC and other universities where similar changes have been proposed). Such was the case with the University of Virginia’s Darden School of Business where a similar proposal has been implemented. The proposal by the Anderson School has now been released for review by the UCLA academic senate and others and provides an excellent description of the principles, benefits and benefits which it might achieve.[6]

The benefit of the change from “privatization” to “self-sufficiency” at the Darden School is the subject of an article by David L. Kirp and Patrick S. Rogers in the Summer 2002 issue of *The Public Interest*.[7] It describes the benefits to the school in much the same manner as those suggested by dean Olian of the UCLA Anderson School in an article entitled, “Giving Up State Funds” which appeared in the online *Inside Higher Ed*.[8] The problems the authors ascribe to the change are the potential to lose sight of the mission of the school and go to extremes in acting like a private business.

The advantages of dropping the term—privatization—in favor of self-sufficiency appear clear. However, just as there are scenarios which involve differing academic units implementing the option (UC, campuses, schools or colleges), there are differences in the degree of self sufficiency involved. So the term “modified self-sufficiency” will be used to describe this option.

## IMPLEMENTATION PROCESS:

Ideally, the implementation of modified self-sufficiency would involve a change in the perceived status of UC. The current arrangement is one in which it is treated as a state agency funded (although the amount of its funding coming from the state is a small proportion of the total) by the regular appropriation process. To work best, UC should be a quasi-governmental organization, designated to provide certain services for the state with which the State enters into a contractual arrangement to provide education, research and related services. It is possible that this arrangement could be accomplished without a change to the California Constitution, since that document, in Article 9, Section 9, already provides for UC to be essentially independent of the Legislature.[9]

Theoretically, the negotiations with the state might be conducted by campus, by tiers (as described below) or by something like the current system-wide administration. In order to continue to obtain some of the benefits which flow from the combination of the several campuses into a single entity and for the sake of simplicity, these negotiations would probably best be retained by the UC Office of the President. If so, that office should exercise that responsibility with active participation of representatives from the several campuses, assuring the maximum benefits at the campus and intra-campus levels.

In operation, the State and the university representatives would negotiate a contract through which the latter would enroll an agreed upon number of students in each of the several undergraduate, graduate academic and professional programs for which a need is determined. A modified self-sufficiency agreement would also provide for research and other activities in areas and levels required.

The negotiation and subsequent accord would provide for qualitative indices on which it would be the University's responsibility to deliver. One of these, for instance, would be accessibility and diversity of the incoming students and concomitant graduation rates by ethnicity and socioeconomic status. On its part, the State would agree to provide a set payment—a subvention—to the University on a lump sum basis and agree to a rolling five-year contract. There could be an annual review to determine if the conditions of the agreement were being fulfilled. If so, a new year would be added and the contract would roll on from year to year.[10]

The accommodation to this change could not be uniform across all of the campuses for a variety of reasons, primarily because of the differences in the ability of each to accommodate to the funding changes which would be required. While a good deal of study would be required to determine the appropriate differentiation, for discussion purposes, assume the campuses are divided into four tiers, based on ability to replace State with non-State funding:

- UC Berkeley, UCLA, UC San Francisco, UC San Diego, and UC Davis;
- UC Irvine and UC Santa Barbara;
- UC Riverside, and UC Santa Cruz; and,
- UC Merced

The number and size of the associated benefits would also vary among these tiers would change along with the relative levels of funding. Of course, the tiers might be constructed differently, e.g., UC Irvine added to the first tier, or UC Santa Cruz included in a fourth tier along with UC Merced. Alternatively, the campuses might be individually categorized, with UCLA or UCSF at one end and UC Merced at the other.

While all of the campuses except UC Merced could probably operate with less state funding under this plan, Merced, which is still in its infancy clearly needs a period of funding beyond its current level if it is ever to become a reasonably sized general research campus in accord with its mandate.

A complete analysis of the financial effect of this approach on the State, UC and the several campuses is not easy to accomplish. But looking in detail at UCLA and extrapolating to the other campuses indicates that increases of the following kind, as an example, would be doable without running afoul of the ability to meet the long-term mission of UC. Something like the following scheme might be utilized:

- For the Tier one campuses, increase revenues by implementing the following actions to a level which will, in the aggregate, provide a minimum 20 percent increase in the funds derived from those sources:

  1. Increase average student fees across the several schools and colleges except for those professional schools which are already at the margin in terms of impact on admissions yield or ability to attract and enroll a sufficient number of highly qualified students;

  2. Increase the number and percentage of non-resident and international students, without reducing the number of resident students to such an extent that overall access would be affected;

  3. Increase income from contract and grant overhead by adjusting rates to be in line with actual costs and comparable charges from other Universities;

  4. Increase income from gifts and endowments by strenuous efforts to increase the percentage of unrestricted giving to a level at or near that of our peer institutions;

  5. Increase the funding derived from self sustaining programs, perhaps by doubling the current amount,

- Increase those rates on Tier 2 campuses sufficiently to provide for the aggregate amount to rise by 10%;

- Increase Tier 3 campus rates sufficiently to increase the yield by 5%; and,

- Leave UC Merced unchanged, until it grows to a level sufficient for it to provide some form of self-sufficiency.

These changes could be accomplished in several ways. For instance, the increase in tuition income could be the result of an across the board, or selective increases among the several categories of students whose fees are already widely differential. The contract and grant overhead could be increased by raising the rate and/or the number and size of the contracts or grants funded by the agencies involved. Increases in private giving called for would be possible by an increase in the total sum, a shift from restricted to unrestricted giving, or both.

Whatever the combination of actions taken to implement the proposed increases, they should be able to be implemented without negative qualitative consequences, and ought to produce sufficient additional income to cover all of the recent cuts in the current level of State support for the first tier.[11] The second group would need approximately $155 million in additional state funds, the third $52 million and Merced $100 million, for a total of slightly more than $300 million. Certainly, these appropriations are within the ability of the State to manage, even under the fiscal constraints which have been described above.

The necessity of dealing differently with the several campuses in this matter is valid also for the sub-units of each. For instance, at UCLA, the Anderson School of Management and the Medical School would be at one end of the spectrum with the College of Letters and Sciences at the other.

# ADVANTAGES FOR UC AND CALIFORNIA:

The advantages to UC from this arrangement are several:

- Tuition could be increased on a regular basis in line with cost of living or cost of education index, providing more funds over time, greater planning ability and less hardship for students, resulting from huge increases after long periods of "holding the line" for political purposes. Contrary to generally held views, the move to even greater tuition should increase accessibility. The key is to increase it on a predictable basis in accord with appropriate cost of education or cost of living increases. Then a substantial proportion of the funds thereby raised would be returned as financial aid—one third has proven to be an effective percentage to date.

- Funds derived from the state would be fungible. That would simplify UC's financial management considerable and allow the administrators close to the action to determine how best to use the funds provided in order to meet their obligation to the State. For instance, if faculty salaries were a major problem, they could be raised within some general policy window, as long as appropriate provision was made for ongoing costs. The same would be true for increasing the number of faculty or for other purposes which were deemed to have the highest priority for that campus at that time.

- A five-year contract would allow for long-term planning to occur, while that is now totally impossible.

- A whole range of substantive and procedural controls would be eliminated. For instance, it has long been estimated that the cost of construction would be reduced by as much as 20 percent if the University could use the good practices followed by its private peers.

- One of the major continuing impediments to private fundraising which still exists despite the great success of UCLA and Berkeley in this regard. Potential donors say, "I give my university contribution to the state in taxes." Under modified self sufficiency, that problem would be ameliorated. In exchange for the advantages which would accrue to UC from adopting the modified self-sufficiency option, the State would be able to assure the quality of its University without the necessity of restoring <u>all</u> of the cuts, unfunded price increases, and under-funded and unfunded enrollment increases that accrued during the Great Recession and before.

## PROSPECTS FOR IMPLEMENTATION:

Getting approval of all the necessary parties and putting this proposed strategy into effect would not be an easy task. Almost every stakeholder involved would likely find the proposal unsettling, too great a break from tradition, too threatening, or worse. The greatest thing in its favor from a political point of view would is that there appears to be no other option which has the possibility of dealing effectively with the problems facing California and UC.

Another positive factor in obtaining acceptance for the modified self-sufficiency strategy that in one way or another, other state universities or parts thereof are moving with varying rates of speed to similar solutions. Some, such as the Universities of Michigan and Virginia, are doing so consciously and with transparency. Others are doing so out of necessity without having worked at the changed arrangements with their state governments which are suggested here.[12]

Undoubtedly the most compelling argument in obtaining acceptance by the state is not only the depth of the fiscal problems it *now* faces, but the fact that—short of major changes in tax policy—it will continue to face those problems due to the structural deficit. In essence, the state cannot afford the University of California at its current level of quality and service.

This same set of facts may also be the motivation for moving the UC community to support such a change. Although UC has faced budgetary crises before there has never been anything to compare with the current problems. There appears to be an increasing understanding within UC that the *status quo ante* is not a viable option, although—as will be noted below—there may be some slippage due to the unrealistic elements in the 2010-11 budget.

## THE 2010-11 BUDGET

As this chapter was being completed, the California Legislature finally adopted a budget for 2010-11, over three months after the beginning of the fiscal year. It was signed by the Governor amid much hoopla that it eliminated the state deficit and restored the reserve in the general fund. In fact, as reported in the *Los Angeles Times*, the budget adopted would:

- Deal with the deficit problem by cutting state worker pay, by trimming public school funding, and by relying heavily on handouts from Washington. It would likely fall out of balance almost the moment the ink dried.

- The spending proposal, which would not necessarily stave off the eventual need for IOUs, also included the sale of state buildings to generate money, rosy revenue assumptions, and a relative "windfall" for higher education, one of the few areas that would see increased funding, in part due to remaining federal stimulus funding.[13]

In short, the 2010-11 budget—like most of its recent predecessors—has been created with smoke and

mirrors. It is a sham in every respect, including the miniscule appropriations for UC and CSU which the *Times* characterizes as a windfall. It is difficult, if not impossible, to imagine how that windfall can be sustained, given the way in which the appropriation became possible. One of the major tricks used in reaching a budget accord and providing for the increase for higher education was, once again to suspend the Prop 98 mandated allocation for K-14. As shown earlier, future budgets will have to make up the amount lost by that piece of legerdemain.

The increased UC funding the budget provides is certainly welcome in that it eliminates some of the unfunded enrollment increases of the past few years; in addition, it covers other unfunded expenditures such as retiree medical insurance costs. But the budget does *not* address the huge costs which will occur during the next few years to bring the University of California Retirement System (UCRS) back towards a fully-funded position. The budget will stave off some otherwise necessary cuts and fee increases. However, the prospect of a future dip in funding resulting from the artificial elements in the budget is a real and compelling concern.

Perhaps the greatest problem it creates is reviving expectations that UC can once again expect the same kind of support which it received prior to the 1990s, therefore rekindling support for the *status quo ante* option. Although falling short of taking that position, President Yudof, in an internet message to UC Faculty and Staff on October 13, 2010, gave the impression that good, hard lobbying with the Governor and the Legislature may in the future resolve the problem, "UC still remains 10 percent below the level of 2007-08. So we must continue our efforts in the next budget cycle. But for now we should celebrate the fact that we're moving in the right direction."[14]

## FINAL THOUGHTS

Even if UC fails to succumb to the call of the status quo ante sirens and continues to respond to the pressure of fiscal disaster staring all of the stakeholders within state government and UC in the face, there are many issues which will have to be resolved. For the academic community, the review of the UCLA Anderson School proposal will be important. It may give a good indication of what lies ahead.

One of the more important issues to be dealt with on all sides will have to be creation of an understanding that increased tuition, if associated with the appropriate amount of financial aid, would not be a detriment to access. Indeed, it would be a boon. Experience both at UC and other universities, as well as a substantial body of research has shown that moderate to reasonably high tuition with a high level of student aid is a better way to provide access than a low tuition approach.

In defending its proposal for tuition increases the Commission on the Future concluded that with the strong financial support program that has been provided, "…UC has been largely successful in remaining financially accessible to students at every income level, as demonstrated by the percentage of low income students we enroll, …student graduation rates and levels of student employment and borrowing."[15] Another very interesting argument for high tuition and high fees was made by the president of Cal State University, San Bernardino. He argued for higher tuition in order to be able to maintain the diversity of the campus.[16]

The viability of continuing increases in tuition is, of course, dependent on increasing financial aid from all sources sufficiently to offset the effect of higher tuition on accessibility. Cal Grants at the state level and Pell Grants at the federal level need to continue to be funded at the highest possible levels. Above

all, however, UC must commit itself to provide institutionally-based aid at a level and type which allows all who are eligible for admission to receive support to enable attendance and graduation without incurring unreasonable amounts of debt.

This vital issue, along with the other elements involved in the move to a modified self-sufficiency option, will require thoughtful and persuasive arguments if it is to be given a chance. Without something like what is being proposed in this chapter, it is difficult to see how the serious problem of funding UC at a level commensurate with its past quality can be resolved. Absent such funding, quality will erode.

However, even with all of the factors pointing toward this approach as the best chance for a continuing high quality university serving the state and nation, nothing can be accomplished without strong leadership willing to think "out of the box" at the top levels of the state and UC. Perhaps the 2010 gubernatorial election will produce such a leader. Even if that miracle were to come to pass, the University of California, with the built in conservative approach to its governance and change, will likely be a more difficult matter. We can only hope the extreme pressures on funding faced by California and its University will result in coalescence around an achievable strategy.

# END NOTES

**1** Legislative Analyst's Office, *Proposition 98 Primer*, February 2005. Available at http://www.lao.ca.gov/2005/prop_98_primer/prop_98_primer_020805.htm

**2** University of California Commission for the Future, *Draft Final Report*, October 2010, pp. 4-5. Available at http://www.dailycal.org/data/files/cotfdraftfinal.pdf

**3** University of California Commission, *op. cit.*, p. 4.

**4** Nickelsburg, Jerry, "California's Volatile Taxes: Healing a Self-Inflicted Wound," *California Policy Options 2010*, pp. 163-179.

**5** Legislative Analyst's Office, *Proposition 98 Primer, op. cit.*

**6** Letter to Chancellor Gene Block from Dean Judy Olian, September 12, 2010.

**7** Kirp, David L. and Rogers, Patrick S., "Mr. Jefferson's University Breaks Up," *The Public Interest*, Summer 2002, pp. 70-84.

**8** Interview with Dean Olian of the UCLA Anderson School of Management in Scott Jaschik, "Giving Up State Funds," *Inside Higher Ed*., September 7, 2010. Available at http:/www.insidehighered.com/news/2010/09/07/ucla

**9** The University of California shall constitute a public trust, to be administered by the existing corporation known as "The Regents of the University of California," with full powers of organization and government, subject only to such legislative control as may be necessary to insure the security of its funds and compliance with the terms of the endowments of the university and such competitive bidding procedures as may be made applicable to the university by statute for the letting of construction contracts, sales of real property, and purchasing of materials, goods and services. California Constitution, Article 9, Section 9.

**10** To be fully effective, this fungibility should include not only operating funds but those provided for capital outlay. Since much of that support from the state is currently made possible through complicated revenue funding programs, further attention would have to be given to the method of effecting this change.

**11** The University of California Commission on the Future, in its *Draft Final Report*, commented on the validity and possible outcomes of initiating all these measures:

- Commenting on page 23 on the tuition issue, it stated that, "there still exists substantial headroom on each campus for across-the-board increases without impacting enrollments. However, at some point consideration of a differential tuition model will come into play.
- On page 16, it reports that, "indirect cost recovery (ICR) rates on federally funded research at UC campuses do not fully recover the cost of research, falling 5-10 percentage points behind some of our competitor institutions and an average of 25 percent short of full recovery."
- On page 22 the report comments that while UC campuses collectively have risen over $1 billion annually for the past few years. The percentage of those funds that are unrestricted as to purpose is only 5%, compared with averages of 20% at other public and 45% at private universities.
- Again on page 14, the authors state that UC's percentage of non-resident students (approximately 6%) is very low compared with peer institutions and that each increase of 10 basis points would yield approximately $20 million added net income.
- And finally, the amount contributed at the present time from income producing activities such as executive MBA programs at the present amounts to approximately $100, an amount which could probably be substantially increased.

**12** An article in *Inside Higher Ed.com* reports that all is not well in the restructuring agreements between the State of Virginia and the members of its university system which had opted for less state funds in exchange for greater freedom of action. If UC were to move in the directions suggested in this article, every effort should be made to ensure that the relationship was one with enforceable responsibilities on the part of the State. See Jack Stripling, "False Ideal?" *Inside Higher Ed.*, September 28, 2010. Available at http.insidehighered.com2010/09/28/virginia

**13** Goldmacher, Shane, "Budget Deal Would Close California's Deficit but Makes Rosy Projection," *Los Angeles Times*, October 7, 2010.

**14** UCLA, *University Communications*, October 13, 2010.

**15** University of California Commission, *Draft Final Report, op. cit.*, p. 13.

**16** "CSU System Being Squeezed," (editorial) *San Bernardino Sun*, September 13, 2010.

6

# JOB LOSS ISSUES FOR CALIFORNIA

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After nearly two years of recession, the United States economy entered a period of slow recovery in the third quarter of 2009. However, jobs in California and the U.S. have yet to truly start recovering. Most of the job growth in the spring of 2010 could be accounted for by temporary hiring for the U.S. Census. For instance, in May, the fifth consecutive month of job growth, there was a net increase of 432,000 jobs. The U.S. government hired 411,000 temporary census workers, but the private sector saw a net increase of only 51,000 jobs.[*] Overall job growth was negative throughout the summer. (See **Figure 1**) (Bureau of Labor Statistics, 2010a, 2010b, 2010c).

At this writing, the unemployment rate in the U.S. still hovers above 9% (see **Figure 2**). The unemployment rate is still higher when discouraged workers (who have given up looking because of poor job prospects) are included. Furthermore, this recession has seen unprecedented levels of long term unemployment.

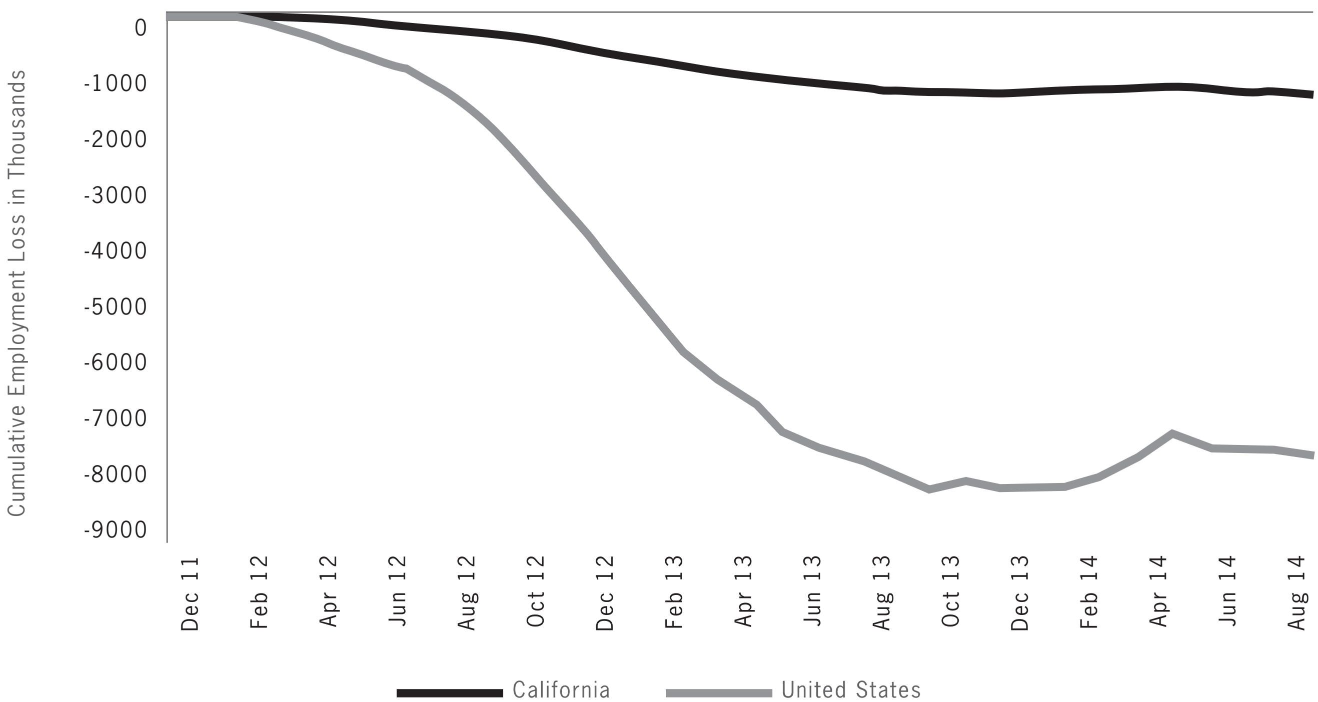
Each month the working age population grows by about 125,000 people. This growth means that about 11 million jobs need to be created in order to return to pre-recession unemployment levels of between 4 and 5%. Even at 5-6% GDP growth, it will take several years to recover these lost jobs. Yet, GDP growth has been much slower to date in 2010 (Bureau of Economic Analysis, 2010). Furthermore, inventory replenishment accounts for much of the growth over the last year. Without aid to boost demand, much needed job growth is not going to occur.

## THE SITUATION IN CALIFORNIA

In California at this writing, more than 1.3 million jobs have been lost since the start of the recession (see **Figure 1**). The number of jobs in 2010 was about the

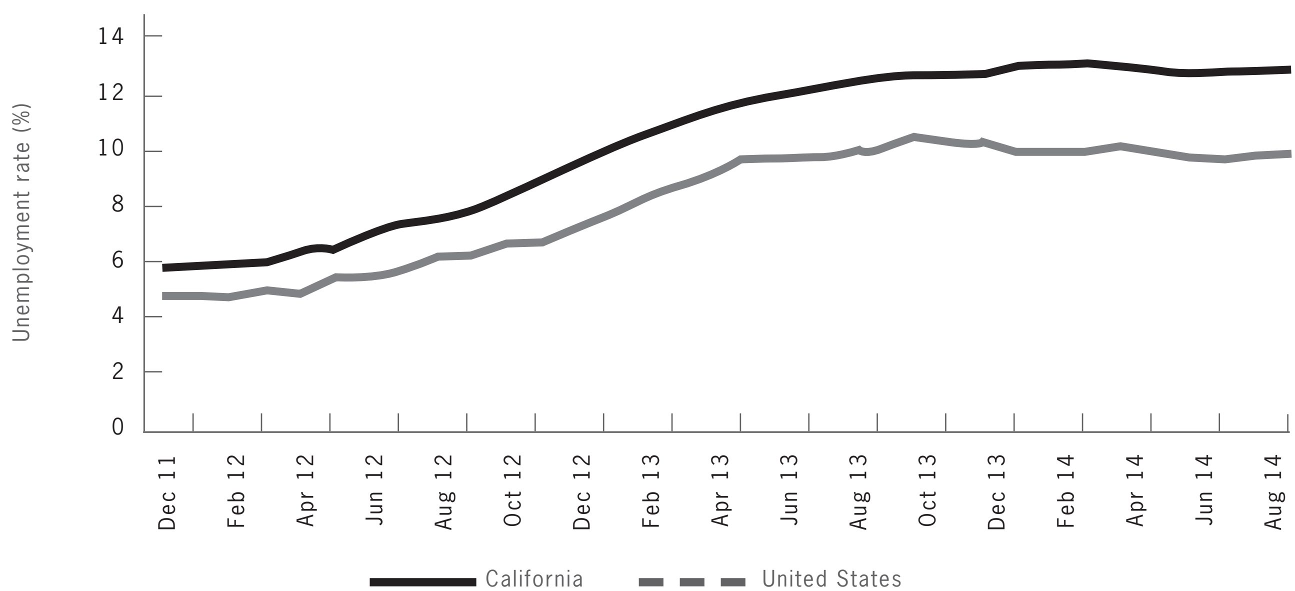
[*] Other government jobs were lost in May such that the public sector had a net increase of 381,000 jobs. Source Bureau of Labor Statistics (2010b).

**Figure 1. Cumulative Job Loss in the United States and California**




Source: Bureau of Labor Statistics (2010d, 2010e)

**Figure 2. Unemployment rate in United States and California since start of recession**




Source: Bureau of Labor Statistics (2010d, 2010e)

same as it was in 1999 when the size of the labor force was much smaller. The percentage of Californians of working age who have a job declined significantly since the start of the recession in December 2007. Additionally, the employment-to-population ratio in California was about 62% at the official start of the recession, but only 56% in the summer of 2010 (Bureau of Labor Statistics, 2010e, 2010h). Like workers across the United States, Californians, too, are taking an unusually long time to find jobs. In 2009, an average of 35% of unemployed people in California were out of work for six months or more and by the second quarter of 2010, this figure had increased to 45.7% (Allegretto, 2010; Bureau of Labor Statistics, 2010i).

Just as the small growth in GDP has not helped the job situation in the country as a whole, the same has been true in California. Furthermore, California faces a tougher road to recovery than does the nation. Even if jobs are created in California at rates similar to that of the United State as a whole, the labor force in California can be expected to grow more quickly than will the labor force in the entire United States. Thus, the unemployment rate in the state is likely to remain higher than that of the country for the foreseeable future.

Indeed, in September 2010, the UCLA Anderson Forecast predicted that unemployment in the state would remain above 10% into 2012. Without even taking into account growth of the working age population in the state, at this writing California was short more than 1.3 million jobs since the start of the recession. Following a recession it takes a long time to get back lost jobs, even when the recovery is strong. During a jobless recovery, it takes even longer. In a jobless recovery, jobs may continue to decline at recessionary rates for some time following the official end of the recession (Bureau of Labor Statistics, 2010e; Nickelsburg, 2010).

## A JOBLESS RECOVERY?

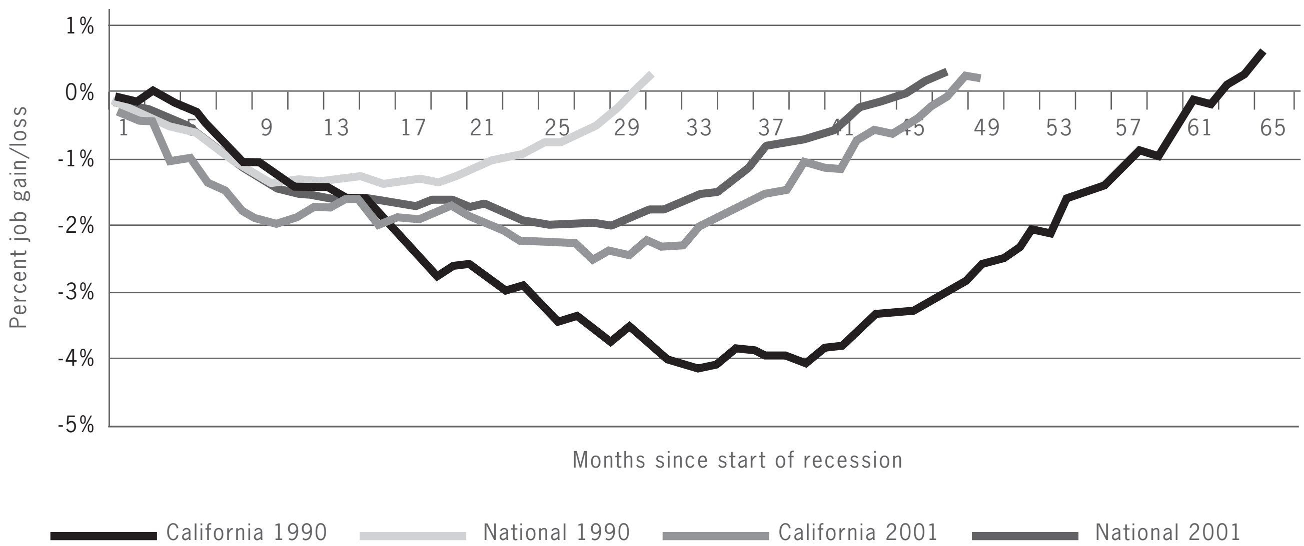
During the jobless recovery following the 2001 recession, both the U.S. and California took a little over three years beyond the official end of the recession to bring jobs back to prerecession levels. However, it took almost two years after the end of the recession in the early 1990s for the U.S. to recover to pre-recession job levels, but more than four and a half years for California to regain the jobs lost in that recession (see Figure 3). If the nascent recovery of 2009-2010 and beyond is indeed a jobless one, then we could expect to see much slower job growth in California than in the U.S. as was experienced in the 1990s.

In both the 2008-09 and 1990 recessions, California fared much worse economically than the country as a whole (see **Figures 3 & 4**) (Allegretto, 2010). Since GDP has recently been growing slowly rather than gaining strength, the country and California seem to be entering a jobless recovery. And given the level of economic uncertainty, a double-dip recession cannot be ruled out.

## JOB CREATION

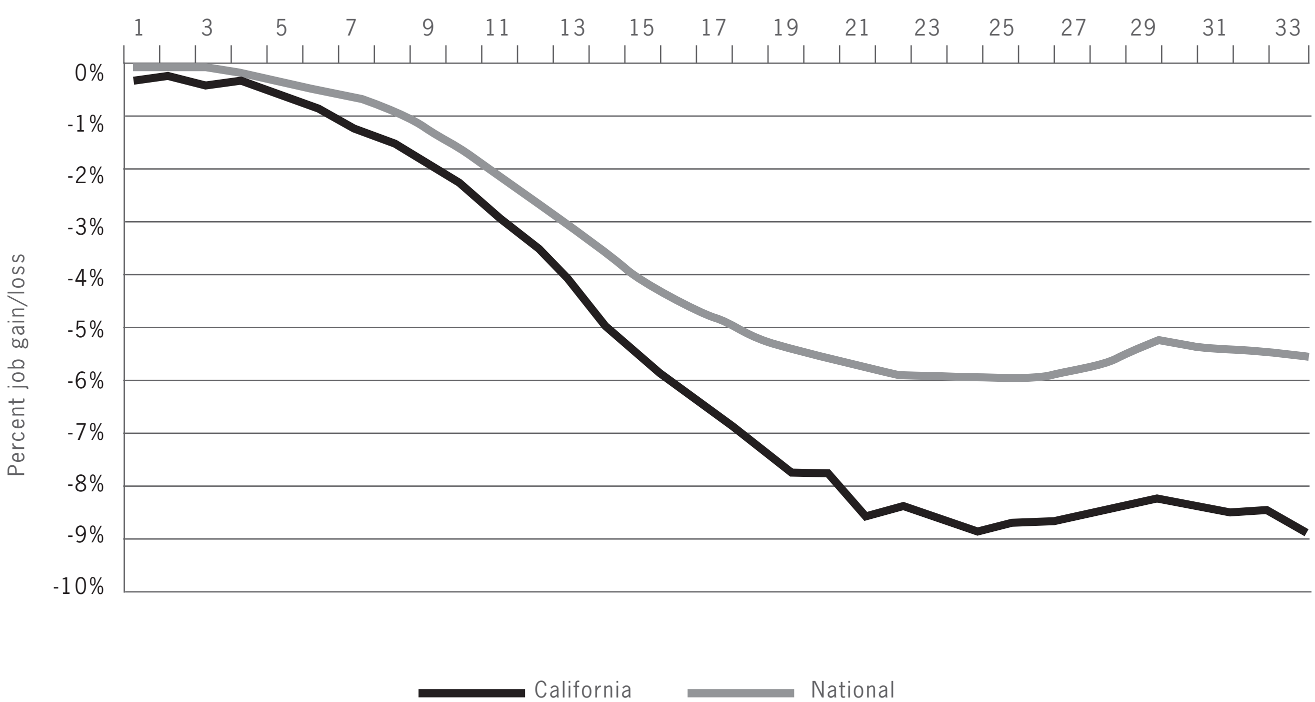
What kind of action can be taken to improve the job outlook? The federal government, which is seemingly able to run a deficit indefinitely, could engage in increased revenue sharing with the states including California. The American Recovery and Reinvestment Act (ARRA, commonly referred to as the "stimulus package") brought some relief to the states through increases in jobless benefits and infrastructure projects. The Congressional Budget Office estimated the impact of ARRA to be significant. By the second quarter of 2010, between 1.4 and 3.3 million people were employed who would not have been employed without the passage of ARRA.

**Figure 3. Months to regain jobs lost in 1990 and 2001 recessions United States and California**




Source: Allegretto (2010), Bureau of Labor Statistics (2010d)

**Figure 4. Percentage job loss since start of current recession United States and California**




Source: Allegretto (2010), Bureau of Labor Statistics (2010d, 2010e)

ARRA also kept the unemployment rate from rising an additional 0.7–1.8 percentage points. Without the passage of ARRA, the national unemployment rate of over 9% at this writing might have been above 10% or even in the 11% range. Furthermore, while the Recovery Act cost $787 billion when it was passed, the jobs, economic activity, and increased tax revenues that it made possible lower ARRA's budgetary impact by as much or more than half of its original cost (Congressional Budget Office, 2010; Bivens, 2010).

However, the stimulus was not enough to make a sufficient impact. More is needed to generate enough job growth to speed up the recovery. Direct job creation programs could be undertaken nationwide and in California. Furthermore, California is one of 18 states with a "worksharing" program (discussed below). But that program has not been used widely enough to produce positive effects. Paid time off for workers, through programs such as worksharing, could help to create or save jobs and lower the unemployment rate. These ideas will be discussed in greater detail later in this chapter.

## IMPACT OF THE GREAT RECESSION— IN WHICH SECTORS IS IT FELT THE MOST?

More than two and a half years after the bursting of the $8 trillion housing bubble and the start of the worst economic downturn since the Great Depression, in the second quarter of 2010, nearly 14% of mortgages were in foreclosure or had at least one payment that was past due (Mortgage Bankers Association, 2010). As a result, residential construction has suffered enormous losses. By June 2010, only 3,000 new residential construction permits were being issued each month for the entire state of California. This number represents an historic low. The UCLA Anderson Forecast predicted that residential construction in coastal areas of California will not continue to contract and could even begin to increase if construction begins on projects that are currently being proposed. However, inland areas are unlikely see an uptick in residential construction for some time to come (Nickelsburg, 2010).

## CONSTRUCTION

The impact on construction jobs has been devastating. In the United States, about two million jobs have been lost in construction since the start of the recession at this writing. Just over one-sixth of those construction jobs have been lost in California. California is struggling more than the rest of the country to recover these jobs because the housing bubble was disproportionately located in the state (Bureau of Labor Statistics, 2010e).

## OTHER PRIVATE SECTORS

The recession has had a significant impact on a number of other industries as well. **Table 1** shows employment changes since the start of the recession in all industries in both the U.S. and California. In California, with 339,000 jobs lost in trade, transportation, and utilities, this sector suffered an 11.6% loss of jobs over the recession. Financial activities and professional and business services also saw substantial declines. Just under 100,000 financial jobs and 211,000 jobs in the professional and business services sector were lost, or 11.1% and 9.3% of jobs in those sectors respectively.

Private sector jobs in the education and health services sector are one of the rare areas that have seen growth. There has been a 3% increase in jobs in this sector in

**Table 1. Employment Changes from December 2007 to September 2010 by Industry for United States and California**

| Industry | U.S. Jobs Gained or Lost | U.S. Percent Change | CA Jobs Gained or Lost | CA Percent Change |
|---|---|---|---|---|
| Total | -7750 | -5.6% | -1372 | -9.0% |
| Construction | -1887 | -25.2% | -327 | -38.2% |
| Manufacturing | -2056 | -15.0% | -214 | -15.5% |
| Trade, Transportation & Utilities | -1924 | -7.2% | -339 | -11.6% |
| Information** | -312 | -10.3% | -36 | -7.6% |
| Financial Activities | -650 | -7.9% | -97 | -11.1% |
| Professional & Business Services | -1317 | -7.3% | -211 | -9.3% |
| Temporary Help Services | -428 | -16.8% | * | * |
| Education and Health Services | 1052 | 5.7% | 52 | 3.0% |
| Educational Services | 152 | 5.1% | 16 | 5.4% |
| Healthcare & Social Assistance | 900 | 5.8% | 36 | 2.5% |
| Leisure and Hospitality | -366 | -2.7% | -82 | -5.2% |
| Government | -146 | -0.7% | -73 | -2.9% |
| State Government | 0 | 0.0% | -4 | -0.8% |
| State Government Education** | 59 | 2.5% | -17 | -7.5% |
| Local Government | -234 | -1.6% | -68 | -3.8% |
| Local Government Education** | -148 | -1.8% | -87 | -8.8% |

*Data not available
**California data not seasonally adjusted

Source: Bureau of Labor Statistics (2010d, 2010e)

California and a 5.7% increase in the U.S. as a whole. With about 16% of all jobs lost in California during the recession coming from the manufacturing sector, California has seen dramatic losses in manufacturing as well (Bureau of Labor Statistics, 2010d, 2010e). California's only auto assembly plant—the GM-Toyota NUMMI factory—closed during the Great Recession. The facility was bought by electric car manufacturer Tesla. But Tesla will employ only a fraction of the original workforce (Abate & Baker, 2010).

## PUBLIC SECTOR

Government jobs in California have fared worse than in the rest of the country. While government positions in the U.S. experienced a slight decline (-0.7%) over the course of the slump, they have fallen more severely in California (2.9% decline) at this writing. The State of California had a major budget crisis, going without any budget at all for over three months of the 2010-11 fiscal year. Similar fiscal distress was felt at the local government level (Allegretto, 2010 Bureau of Labor Statistics, 2010d, 2010e).

## IMPACT OF THE GREAT RECESSION—WHO IS FEELING IT THE MOST?

For most of this recession, men have disproportionately seen their jobs disappear. This job loss has occurred because the recession was a result of the bursting of the $8 trillion housing bubble and male dominated industries such as manufacturing and construction were hit hardest. But the disproportionate male-female job loss gap has been closing as many industries with a higher proportion of female employees are experiencing continued job loss. Public sector jobs are likely to continue to be lost as states try to balance their budgets. Fiscal distress in government and the spread of economic difficulty seems likely to lead to continued reduction of positions in industries dominated by women.

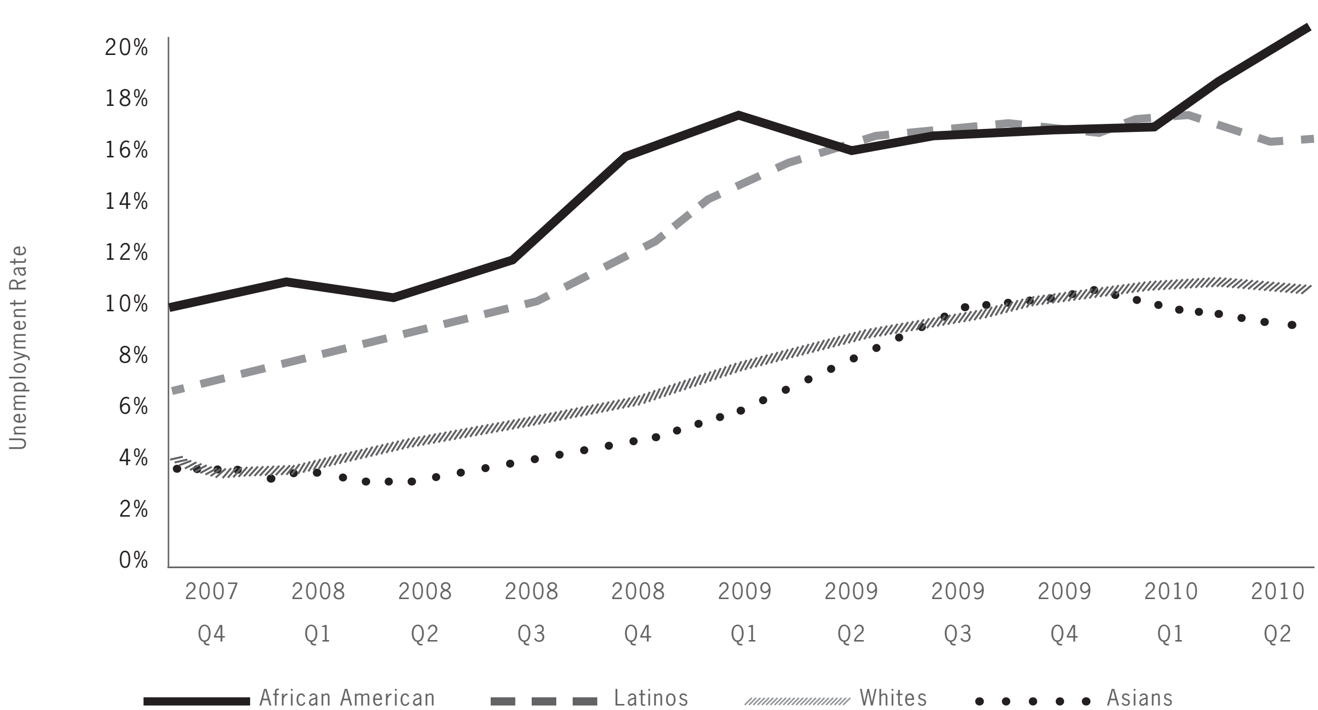
In California, average unemployment rates in 2009 were 14.3% and 14.7% for African Americans and Latinos, respectively. Unemployment for these groups continued to increase into 2010. While the unemployment rate for Asians appears to be similar

to the rate for whites, that figure does not tell the whole story. Asians comprise many different ethnic groups; some groups are having a harder time finding work in this recession than others. It is not possible to understand the full impact of the recession on the various ethnic groups using only the broader Asian category (see **Figure 5**) (Bureau of Labor Statistics, 2010j; Reidenbach & Weller, 2010).

The unemployment rate differences between racial and ethnic groups have not been as dramatic in California as in the U.S., ranging in the state from 31.7% among white youth to 37.4% among Latino youth in 2009 (see **Figure 6**). Still, with one-third of young people out of work in California and more than a quarter out of work in the country as a whole, a generation of young people is entering the workforce with limited job prospects. Without direct intervention, the Great Recession could have ramifications for years to come on the poverty rates, marital rates, crime rates, and mental and physical well-being of these young people (Bureau of Labor Statistics, 2010j).

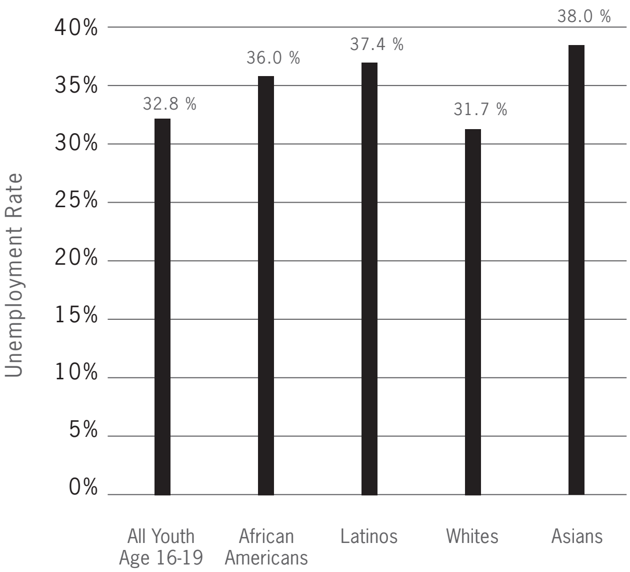
Californians at every educational level are faring worse in economic slump than are individuals at the same educational level in the country as a whole. Education positively affects individuals' employment chances, with the most educated workers experiencing the lowest levels of unemployment. However, the gap between California and U.S. unemployment rates was wider at the lower educational levels. (See **Figure 7**) (Bureau of Labor Statistics, 2010f, 2010k).

**Figure 5. Change in unemployment rate in California by race/ethnicity 4th quarter 2007 through 2nd quarter 2010**



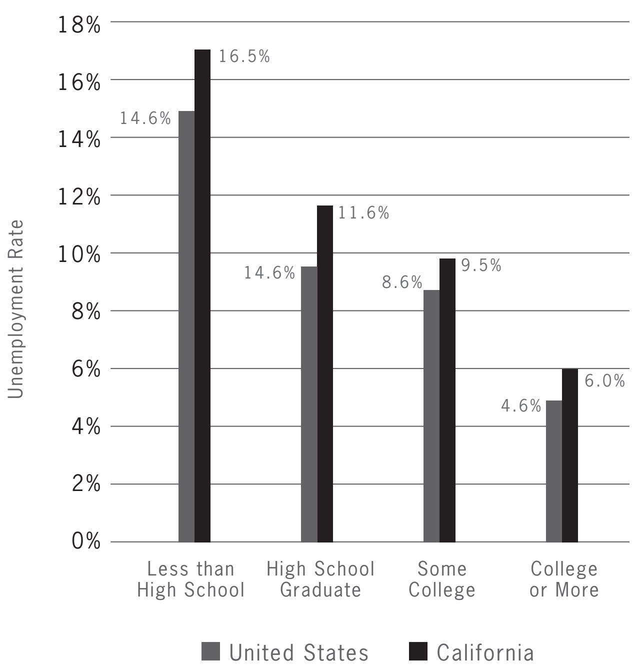

Source: Allegretto (2010), Bureau of Labor Statistics (2010d, 2010e)

**Figure 6. Average unemployment rate in 2009 of youth in California by race/ethnicity**




Source: Bureau of Labor Statistics (2010j)

**Figure 7. Average unemployment rate in 2009 in United States and California by education level**




Source: Bureau of Labor Statistics (2010f, 2010k)

# IMPACT OF THE GREAT RECESSION ON FAMILIES

Women represented almost half of nonfarm payroll employment in 2009 (Bureau of Labor Statistics, 2010c). When the economy began shedding jobs, the majority of them in manufacturing, construction and other industries that are major employers of men, many married women became the main, or even the sole, earners for their families. Prior to the recession, many of these same women workers were providing the secondary of two incomes. Female heads of households also comprise a significant proportion of working women today. Indeed, women provide a significant income for two-thirds of families with children. Women are breadwinners (i.e., bringing home 50% or more of the household income) in anywhere from one-quarter to nearly two-thirds of families with children, depending upon the state (See **Table 2**) (Boushey, Arons, & Smith, 2010). Source: Boushey, et al. (2010) based on Ruggles, Alexander, Genadek, et al. (2010).

Despite the fact that more jobs have been lost by men in the Great Recession, women's job loss reached extremely high levels not seen in the last several recessions. The unemployment rate for Californian women in 2009 was 10%. Unmarried women with children, who are generally unemployed at higher rates than married women or married men, saw this trend continue during the recession. Single mothers in California experienced 14.8% unemployment. Furthermore, single mothers saw their work week grow shorter, from an average of 38.6 hours in 2006 to an average of 36.6 hours in 2009, making it even more difficult for women to support their families (Anderson, 2010a).

Public sector jobs, which are disproportionately held by women, are likely to continue to be lost in

**Table 2. Percentage of mothers who are breadwinners by state in 2008**

| State | Share of working mothers who are bread winners | State | Share of working mothers who are bread winners |
|---|---|---|---|
| Alabama | 42.4% | Montana | 36.9% |
| Alaska | 41.8% | Nebraska | 37.3% |
| Arizona | 38.9% | Nevada | 39.5% |
| Arkansas | 45.2% | New Hampshire | 34.5% |
| **California** | **37.7%** | New Jersey | 37.0% |
| Colorado | 36.4% | New Mexico | 43.4% |
| Connecticut | 40.2% | New York | 43.4% |
| Delaware | 44.4% | North Carolina | 42.7% |
| District of Columbia | 63.8% | North Dakota | 35.0% |
| Florida | 44.2% | Ohio | 42.4% |
| Georgia | 42.7% | Oklahoma | 39.7% |
| Hawaii | 37.7% | Oregon | 37.1% |
| Idaho | 34.9% | Pennsylvania | 39.8% |
| Illinois | 38.6% | Rhode Island | 43.4% |
| Indiana | 40.7% | South Carolina | 45.9% |
| Iowa | 38.8% | South Dakota | 41.9% |
| Kansas | 40.1% | Tennessee | 41.3% |
| Kentucky | 41.6% | Texas | 38.0% |
| Louisiana | 44.2% | Utah | 25.5% |
| Maine | 42.4% | Vermont | 45.3% |
| Maryland | 43.8% | Virginia | 39.5% |
| Massachusetts | 39.6% | Washington | 37.4% |
| Michigan | 41.2% | West Virginia | 39.8% |
| Minnesota | 39.1% | Wisconsin | 40.1% |
| Mississippi | 48.4% | Wyoming | 31.4% |
| Missouri | 42.4% | | |

Source: Boushey, et al. (2010) based on Ruggles, Alexander, Genadek, et al. (2010).

significant numbers unless the economy turns around faster than forecast. Without an increase in women's employment, families already struggling to get by will find it even more difficult to make ends meet. Among those women who are employed, the ability to close the gap in household income when a spouse loses a job is compromised by the fact that women are still paid less than men. Note that women in full-time jobs had median weekly wages at a level a little over 80% of men in 2009 (Institute for Women's Policy Research, 2010).

Even before taking into consideration gender-based wage differentials, the impact of this gender pay gap on families is particularly pronounced for women without a college degree. They are more likely than those with college educations to find themselves in low-wage jobs (full or part-time) which often do not provide a living wage. Furthermore, these jobs offer little in the way of health insurance or personnel policies that would enable women to attend to both their work and family responsibilities. With the higher proportion of men's jobs lost in due to the economic slump, women, who earn significantly less than men, will increasingly be the main breadwinners for their families. Thus, it is important that job creation strategies should focus on better paying and better quality jobs, particularly among low-paid women's jobs. Otherwise, families will continue to suffer (Appelbaum, 2009).

## EFFECTS OF LONG-TERM UNEMPLOYMENT

The Great Recession has been associated with unprecedented levels of long-term unemployment. The longer one goes without having a job, the harder it becomes to find a job. In late 2009, fewer than 10% of people out of work for six months or more were finding work in a typical month compared with nearly a third

of those who had lost their jobs within the previous four weeks. With nearly 42% of unemployed people in the U.S. taking six months or more to find a job and the average job search for unemployed Californians lasting eight months, long-term unemployment poses a serious problem that will have ramifications that go beyond the current economic crisis (Anderson, 2010b; Bureau of Labor Statistics, 2010c).

The difficulty experienced by the long-term unemployed in finding work may be due to several factors. After being out of the workforce for six months or more, workers begin to lose skills and are no longer aware of the latest techniques and technology in their field. Unemployed individuals are often isolated from their social networks. After many months, it may become more difficult for them to connect with the informal job networks they may have created while employed (Anderson, 2010b).

Even if a person out of work for six months or more does eventually find a job, he/she will experience greater reductions in pay than those out of work for shorter periods (Pew Economic Policy Group, 2010). People who remain out of work for a long time may also become discouraged and give up, leaving the labor force altogether. Once out of the labor force, these individuals are no longer counted in the official unemployment statistics. Thus, the number reported by the Bureau of Labor Statistics may actually be an underrepresentation of the long-term unemployed.

Finally, there is a stigma associated with being out of work for a long time. While employers may be aware that finding a job is very difficult with such large-scale unemployment, employers are still less likely to hire those with a gap on their résumé. With more than five unemployed workers for every job, employers can afford to be picky about who they hire. As employers hire more newly unemployed, the percentage of the unemployed who have been out of work for a long time may continue to increase.

## PSYCHOLOGICAL IMPACT OF UNEMPLOYMENT

The physiological and psychological effects of unemployment and long-term unemployment are well established. Previous research has demonstrated increases in deaths due to cardiovascular problems, cirrhosis, and suicide, increases in alcohol abuse and increases in violence and arrests among the unemployed (Brenner, 1979; Catalano 1991; Catalano, Dooley, Navaco, Wilson, & Hough 1993; Catalano, Dooley, Wilson, & Hough, 1993, Catalano, Novaco, & McConnell, 1997, 2002; Dooley, Catalano, & Rook, 1988; Dooley, Fielding, & Levi, 1996; Kessler, Turner, & House, 1988, 1989; Kposowa, 2001; Liem & Liem, 1988; Smart, 1979; Warr, Jackson, & Banks, 1988). Furthermore, longer stints of unemployment lead to a greater impact of unemployment on psychological well-being (Liem & Rayman, 1982).

## WHAT CAN BE DONE TO CREATE JOBS?

California faces pressures in financial markets to balance its state budget which the federal government does not. If the federal government were to engage in increased revenue sharing with the states, it could take some pressure off state and local governments in California. The $26 billion dollar education bill passed in August 2010 was an example of this sort of revenue sharing. California was scheduled to receive $1.2 billion for education jobs which had the potential to save or create 16,500 positions. (Velazquez, 2010; Chea, 2010).

## FEDERAL FISCAL POLICY

Funding from the federal government can help state and local governments hold on to public sector jobs. Increased spending has been shown to provide a bigger boost to the economy than tax cuts. Furthermore, tax incentives to employers who hire unemployed workers do not necessarily create new jobs. During the recession, many more jobs have been lost than added, yet each month a large number of jobs are created. These tax incentives may reward employers for hiring unemployed workers for jobs that would have been created anyway.

While this outcome is fine for the unemployed worker who obtains a job, it does not do anything to create net new jobs. Some unemployed workers may be hired as a result of these incentives. But if there is little net increase in the number of jobs created, then the total number of unemployed will be little affected (Allegretto, 2010; Baker, 2009).

Long-term unemployment in California is still at very high levels at this writing. Thus, extended unemployment insurance benefits are needed now more than ever. Nationally, over 1.2 million full-time equivalent jobs were created indirectly through the extension of unemployment insurance benefits beyond the normal 26 weeks, COBRA subsidies, and funds through the federal stimulus package (Mishel & Shierholz, 2010). Furthermore, it appears that the extended benefits are not increasing the length of time workers remain unemployed.

A Federal Reserve Bank of San Francisco study found that the extension of unemployment benefits did not have a substantial effect on the unemployment rate. Without these extensions, the national unemployment rate would likely have been just slightly lower at 9.6% instead of 10% at the end of 2009 (Valletta & Kuang, 2010). Similar results could be expected in California.

## WORK SHARING IN CALIFORNIA

In addition to unemployment benefit extensions, the work-share or short time work program in California should be expanded. Greater utilization by employers and workers of the program should be encouraged. Short time work programs are a way to create or save jobs by making use of the unemployment insurance system. These programs enable companies to keep people on the payrolls at times when the firms need to cut expenses. Rather than laying off a few employees, the employer saves money by cutting the hours of many employees. Employees are paid by the employer for the hours they do work *and* they are paid through unemployment insurance funds for a proportional amount of their unemployment benefit for the hours they did not work (Employment Development Department, 2009).

For instance, if a worker's hours were cut by 25%, he/she would receive 75% of normal salary from the employer, plus 25% of his/her unemployment benefit. Thus, employers would save money and employees would only see a 5-10% decrease in salary. The government would spend little or no more than it already does for unemployment benefits. And any additional costs would be no more than any other tax incentive for businesses (Baker & Hassett, 2010; Employment Development Department, 2009).

Eighteen states, including California, have short time work programs. California was the first state to establish work sharing in 1978. Short time work programs in California are financed through state Unemployment Insurance payroll taxes and paid from state trust funds. However, since unemployment insurance is a joint state and federal program, employer incentives could be an add-on to the Unemployment Insurance system that the federal government could support. With federal support, there would be no added burden to the state.

California had an increase of 78% in initial work share claims between 2007 and 2008. With unemployment holding at 12.4%, use of the short time work program in California has not been widespread enough. This program when broadly used has been demonstrated to keep unemployment rates from rising or even reduce rates. It needs to be expanded to stop continuing job loss in California (Employment Development Department, 2009; Ridley, 2009).

Short time work programs have benefits that go beyond job creation. Because workers keep their jobs, they continue to receive benefits such as health care, maintain their job skills and may even build skills by training on days when they are not working. Entry level and less experienced workers, who are most vulnerable in weak economy, are less likely to lose their jobs. In addition, employers retain skilled employees, reducing costs of recruitment and training when economy recovers. Short time work programs also provide a benefit to government and society by keeping more people employed and productive (Employment Development Department, 2009; Ridley, 2009).

## CONCLUSION

The unemployment rose in California to over 12% during the Great Recession. Long-term unemployment reached very high levels and nearly a third of California's youth in the labor force were out of work. Every month the labor force continues to grow as potential workers enter or re-enter the labor force. Until there is rapid job creation, the effects of the Great Recession on current and future worker earnings will continue to grow. Without the enactment of policies that provide a boost to the economy, either through direct spending or job saving measures, jobs will be slow to recover in California. The situation in the state could remain bleak for years to come. Aid to the states from the federal government and the utilization of job saving policies such as work sharing could help to alleviate the jobs crisis in California.

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# 7

# THE PUBLIC POLICY OF CALIFORNIA COMPETITIVENESS: A SCORECARD APPROACH


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The *Financial Times* recently ran a country promotion seminar ad with the banner title, "Ukraine: Reforms, Competitiveness, Investments."[2] The topics of this seminar included discussion of economic reforms to improve the Ukraine's business climate, new investment opportunities in key industries, and the investment attractiveness of Ukraine's regions. The Ukraine, a resource-endowed country with an unstable political economy, was making a pitch to the world to reconsider it as a place to do business. Promotions such as these in many countries and regions are becoming increasingly common as globalization makes the competition for business attention a "must do" for most governments.

It has been a long time, if ever, that California has run an international ad to attract attention to itself as a place to do business. It has not needed to. California has been a dynamic economy for a very long time. The increase in international trade competition over the last 30 years has resulted in the loss of jobs in manufacturing in the Golden State. But it has also generated many new jobs and businesses. Yet, given the changing conditions and prospects for California's political economy in the next few years, it is not hard to imagine that sometime in the near future we might see similar promotional ads for California.

These ads would talk about how significant political and economic reforms now support a friendlier investment and business climate in the state and how regulations have been minimized and streamlined to allow for better business decision-making. They would describe how the California labor force, now cheaper but talented, is eager to work and how new business/government collaborations are encouraging new Silicon Valleys to grow in other parts of the state. While such ads have not yet appeared, and may not, one cannot ignore the proverbial writing on the wall. Like an aging Hollywood star, California may need a lot more than a facelift and a good agent to stay in the globalization game. Central to remaining a player in that game will be the competitiveness of its political economy.

## THE SIZE ARGUMENT

The California economy has often been described by statements such as "if California were a separate country, its economy would rank as the 6th or 7th largest in the world—larger than France (!) and larger than some combined number of countries." These statistics are often reported with a mild sense of awe (and a certain amount of pride). But they also reveal ignorance as to what this ranking really means and, more importantly, how California earned that ranking.

In these statements a superior competitiveness is assumed. But that competitiveness is now in question at a particularly important time when the Pacific Rim appears to be the rising center of economic and innovative hegemony for the next fifty years. So how can California continue to remain a significant player in this new political economic game? The answer is twofold: 1) a careful analysis of the game, and 2) a plan or strategy to play the game.

## A COMPETITIVENESS POLICY FOR CALIFORNIA

The purpose of this chapter is to examine the issue of state competitiveness and the way in which California might develop a more focused public policy of competitiveness.[3] For example, most U.S. states and many cities and regions have some form of trade promotion programs for their local political economy. Is it a wise expenditure of resources to have trade missions, have cities in competition for foreign business, or name various duplicative boards and commissions for trade promotion? Are they simply sales agents for California based companies? Or do they have a wider purpose? If the former, what is the return that California earns on its sales efforts on behalf of private firms that presumably can promote themselves? If the latter, what is the wider purpose of these efforts and is that purpose being accomplished? We argue below that the *ad hoc* nature of California's competitive policy inevitably leads to less-than-satisfactory results.

For a state with limited public resources, this conclusion should be a concern. Yet the policy argument is broader than just trade missions. And the answers we derive may have profound effects on the future shape of the California economy.
The 2010 political season saw a host of proposals to make California more "business friendly," to deepen California's infrastructure, and to trade off environmental concerns against costs of business operations- all in the pursuit of more jobs. These proposals are all, at their core, reflections of concerns about the competitiveness of California's hundreds of thousands of individual enterprises. And the issues raised need to be addressed in a unified way. We propose one such methodology in what follows.

## A MULTIDISCIPLINARY PERSPECTIVE ON COMPETITIVENESS

Our position is that understanding competitiveness and a strategy for remaining competitive is inherently a multidiscipline activity. From a policy perspective, we see two disciplines that inform the question of competitiveness policy. The first is Economics—which is a theoretical and empirical based analysis of transactional activities that looks at fundamental exchange processes and trends. Its purpose is establishing an empirical basis for discussion and decision about the allocation of resources to activities. Economists have studied the concept of comparative

advantage in depth. But less work has been done in defining competitiveness and in analyzing the dynamics of changing comparative advantage. Of particular relevance is the literature on trade theory, growth, and economic development.

The second perspective is the normative Management view. That approach explores how policy becomes defined and executed in programs implemented by organizations and people in the practice of management. Management is a professional discipline involving both practice and improvements in practice. It defines competitiveness in terms of the effectiveness of organizational outcomes and the processes, structures, and culture that shape them.

Both perspectives assume purposeful rationality in thinking and behavior. But they often look to different criteria on which to judge decisions. For example, economics is fundamentally concerned with productivity, efficiency, markets and competition issues in the use of resources. Management is concerned largely with organizational effectiveness, goal achievement, leadership, and motivation/performance/reward issues. In both disciplines the issues of power, equity, fairness, and complexity are inherent and confounding concerns. Thus, both of these disciplinary perspectives are woven into the arguments presented below. Put another way, the task of defining competitiveness is challenged by these two perspectives.

In one sense, the definition of competitiveness is simple. We can say organization X is competitive if it is winning, doing better than it did before, doing things it never did before, or pulling ahead of the other guys! This view focuses on end results only. It is the sporting/gaming view of competitiveness.

On the other hand, understanding *how and why* X is winning or losing, moving ahead or behind, or doing the "same old stuff," is a much more difficult analysis. Furthermore, the real interest is in the sustainability of a winning record and in the turnaround strategy needed to reverse losing record. Any X that is winning, wants to keep winning. Any losing X wants to stop losing. If you watch weekend sports on television, you see this kind of competitiveness analytics immediately; it takes 10 seconds to mention the final score and maybe 3 minutes to show the highlights of the winning plays. However, the pre- and post-game talk shows engage in hours of discussion and debate about what team X should do or should have done, the mistakes it made, changes it needed to implement, and so on. So while best score determines the winner at the end of the game, repeating the win IS the game. California has scored well in the past and has a winning record. Is that winning record sustainable? The underlying factors that contribute to its competitiveness will determine that.

## A NORMATIVE VIEW FOR CALIFORNIA

Our approach to California competitiveness is framed as a normative policy point of view. Should California seek to adopt policies and practices to improve its competitive position in the world market place? If so, what are the key elements of a state global competitiveness strategy that public policy needs to have and to support? Note that in this analysis we are aggregating the economic activities of many and varied industries whose competitive dynamics differ into a single California perspective. We do that because the state of California is the unit of analysis from a state policy perspective.

We begin with a review of comparative and competitive advantage. Then we focus on the state of—and dynamics of—California's comparative and competitive advantages. Lastly, we address the managerial aspects of competitiveness policy highlighting a scorecard approach to competitiveness management at the state level.

## COMPARATIVE ADVANTAGE AND COMPETITIVENESS

The concept of comparative advantage is an old one in economics. Textbooks often cite the example given long ago by David Ricardo of the trade in wine and wool between England and Portugal.[4] Although the concept has since been expanded to include factor endowments (labor and capital) and although economists now distinguish between internationally traded and non-traded goods, the central idea has remained the same.[5] Specifically, there is a constellation of endowments that California possesses. Given free trade between California and other states and nations, there are some goods and services which Californians will be able to produce at a cost which will earn them a profit—and some which they will not.

This specialization and trade is to the advantage of both California and its trading partners. Which goods they will export and import, and the price at which they will trade, is an empirical question. But the notion that there always exists a comparative advantage is both logically sound and consistent with actual observation.[6]

The fact that there are some goods and services that Californians are better at today does not address the question of future competitiveness. For example, California used to be one of the best places in the world for the manufacture and assembly of commercial transport aircraft. Douglas, Lockheed and Convair factories turned out the majority of planes used by the world's airlines. Today that is no longer true. All of the commercial air transport assembly lines are silent, although some limited military assembly remains. The lesson: California once had a comparative advantage in engineering, systems integration, design, and assembly. But changes in aircraft technology, the increasing cost of land, new developments in telecommunications and automation, and other variables changed that situation.

Moreover, there can exist a theoretical comparative advantage which is not an actual or realized one. For example, consider a population of very tall people who do not know how to play basketball. Their height is a precondition to an actual comparative advantage over others with shorter populations. But until they actually know how to play the game successfully, the potential will remain untapped. So it is not just in the existence of the preconditions to particular advantages that determines competitiveness but also their use and application.

For purposes of this chapter, we will define realized *comparative advantage* as a non-decreasing sales and market share. This is an outcome measure. For example, the fact that California lost its competitive advantage in the production of transport aircraft is evidenced by decreasing sales and market share and—ultimately—by the departure of the major companies engaged in this activity. In other words, we can say that California has a competitive advantage in some good or service if its comparative advantage is non-diminishing. This concept is different from a specific firm having a competitive advantage which could stem from a better sales force, product support, pricing strategy among other factors.[7]

In the 1980s and 1990s, California was becoming increasingly less competitive in aircraft assembly even while it was becoming more competitive in sophisticated unmanned aerial vehicles. It still had a comparative advantage in high-tech competencies. However, since it did not have a competitive advantage in the marketplace for the assembly of transport aircraft, it eventually lost its comparative advantage.

of Long Beach, LA and Oakland is so great that it is very difficult for Savannah, Houston and Norfolk to compete against them successfully or easily.

## THE SOURCES OF CALIFORNIA'S COMPARATIVE ADVANTAGE

To understand what is currently happening to California's competitive advantage, we need to understand the sources of California's comparative advantage. It is actually quite easy to name most of them because they have become part of the fundamental image and reputation of California worldwide as a place to do business. They are location, a skilled labor force, an international population, rich agricultural land, deep water ports, abundant natural resources, knowledge communities, abundant tourist sites, and good weather.

These characteristics read like a tourist ad designed to showcase the attractive qualities of a place that offer promise of competitive advantage by virtue of their abundance, ease of access and availability, quality, and, of course, cost. But there are two basic kinds of advantage here: the given natural advantage that exists by virtue of geography and location and the developed advantage that exists by virtue of human activity, institutions, and decisions. Among the former, rich agricultural land, abundant natural resources, abundant tourist sites, and good weather are not apt to be imperiled by changing economic conditions elsewhere; their basic conditionality has not changed

California's deep water ports and location at the edge of the Pacific Rim are not entirely immune from competitive pressures from other ports on both coasts of the United States. But they only require normal care and feeding to remain the most attractive and cost effective means for the transfer of goods to and from Asia through California and the rest of the U.S. In this case, the geographical advantage of the ports

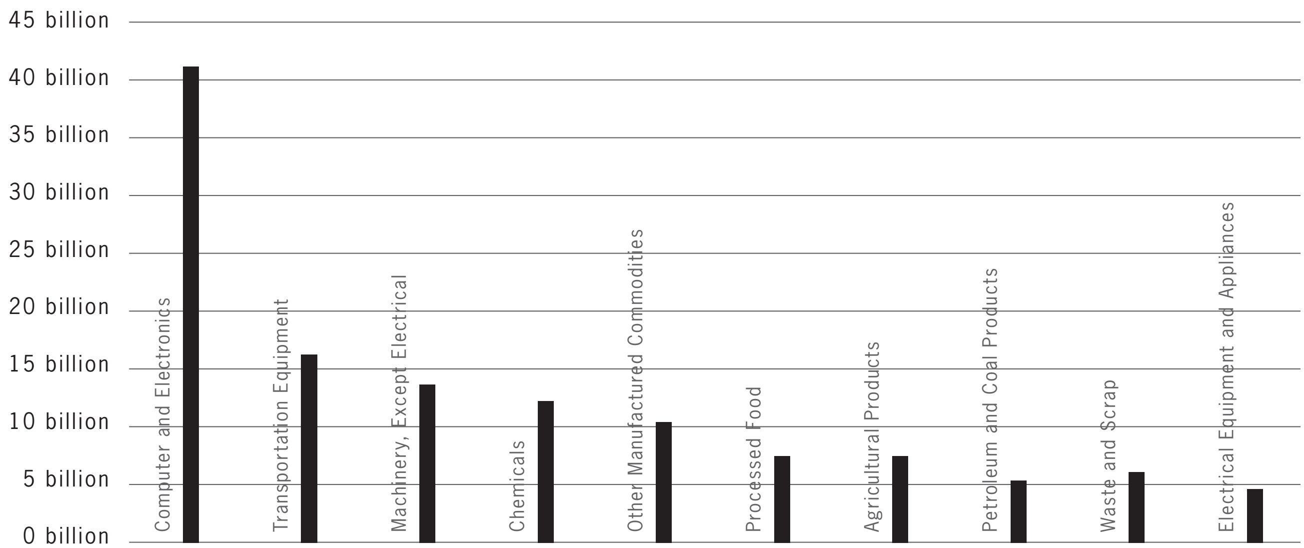
## THE PATTERN OF CALIFORNIA EXPORTS

Some of California's competitive industries can be seen on **Figure 1**, California Exports.

California's top three exports, computers and electronics, transportation equipment, and machinery are directly related to California's knowledge communities and skilled labor force. The balance of the top 10 exports (excluding education and tourism) are dominated by California's natural resources and agriculture. In contrast to geographical advantage, the development of skilled labor, knowledge communities and the conditions that attract talented international populations, are generally neither wholly natural nor fixed. They are created by human institutions, are movable, and may be affected by public policy elsewhere.

Why does California have a comparative advantage in knowledge communities and skilled labor force? Recognizing that knowledge communities demand more life-style options, service support, amenities and higher quality employment in their location decisions, the nature of place becomes a very important factor in the attractiveness of an economy to a talent pool. First and foremost, California has a basic globally valued attraction in location and geography. Its mild weather provides ample opportunities for outdoor recreation. Its beaches and mountains provide a pleasing place to live and visit that is in great demand. In addition, California's location on the Pacific Rim continues to provide certain advantages in doing business with the rising Asian markets. So attracting a pool of potential talent to its geography is a starting point. But this pool of talent is contingent on employment, education, and

**Figure 1. California Export, 2008**




amenities for family life. Developing and refining that pool can be a matter of policy.

## CALIFORNIA'S PUBLIC AND PRIVATE INFRASTRUCTURE

In California, there have been substantial investments in public and private infrastructure which have, intentionally or not, leveraged its comparative geographic advantages. These include highways, ports, public parks, tourist attractions, and airports.[8] But more important, investment in higher education and research institutions[9] over the years has produced an extraordinary advantage in a ready source of well-trained technicians, scientists, and engineers for California industry.

Currently with only 12% of the U.S. population California has 28% of the top 25 engineering universities, 20% of the top 25 computer science universities, 32% of the top 25 biomedical universities, and the leading college of automobile design. It has an entertainment industry which provides 40% of all sound and motion picture entertainment jobs in the U.S. The benefit of these knowledge communities extends beyond their education or entertainment function to the development of cutting-edge technology, new products, and eventually new industries that employ others.

There is however, a possible downside to an advantage in education. A knowledge-based source of comparative advantage, unlike the rich agricultural land of the Salinas Valley, is dynamic and not static, i.e., subject to gain through improvement or loss through mismanagement. It is contingent, i.e., subject to situations and conditions. This type of advantage, by its nature, is more complex to grow and maintain. It can be put into a special class of variable competitive advantages.[10] So while California can celebrate its comparative advantages which have served so well in the past, there is little reason to be complacent about the permanence of any dynamic-contingent advantage. There may be gains and losses to advantage, some of which is under California's control, and some is not.

## LOSS OF CALIFORNIA'S COMPETITIVE ADVANTAGE?

Is California losing its competitive advantage? The quick answer is yes, no and maybe. It might be argued that the appropriate way to answer this question is to examine the performance of sales relative to markets, industry by industry, at a very micro level. That task is beyond the scope of this chapter and—perhaps—not necessary. If a particular industry is not competitive (as in our example of the assembly of commercial transports), it is not clear that there are any policy implications nor that government micromanagement intervention is required. The market usually solves the problem.

Competitive advantage changes all the time at the micro level. Such changes are not perforce bad. But the overall performance of California industry, as an aggregate system of production, is important. Countries, states, and regions can become stuck in low growth and low per capita income episodes if the goods and services in which they have an advantage in are not high value added. Economists have long known that part of the problem of broad development in the less-developed countries is their dependence on a comparative advantage in primary commodities as their engine of growth. By their nature, primary, or less differentiated commodity products like coffee, are mainly price competitive. They tend to experience wide price swings and thus present higher uncertainty and risk to those producers. So having a comparative advantage, which all states and countries have in some goods, is not a sufficient condition for a high standard of living for the population.

## EXPORT GROWTH AS AN INDEX

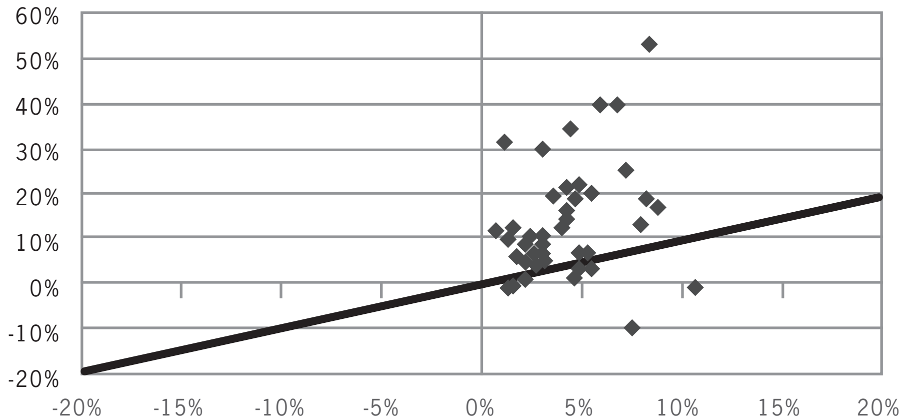
A positive datum that gives us a macro view of California's competitiveness over the last few years is the growth of exports from California to its trading partners. If those exports are growing faster than the recipient country's GDP, then California goods are gaining overall market share and are competitive (and, conversely, if they are not). Viewed in this way California is doing quite well. In most cases exports are growing faster than recipient country GDP.

**Figure 2** plots growth in GDP of the country importing goods from California and the growth of those California exports. We can see from the figure that for most of California's trading partners the plot is above the 45-degree sloped equal growth line. That is, exports from California are growing faster than the country itself and, therefore, California's market share is increasing. A few are clustered at the equal growth line indicating California business is holding its own, and there are only two outliers, China and Israel, for which overall market share declined. So up to this point, and inspite of California's legendary problems with state government budgets, taxation and regulation, the competitiveness of California business remains.

## THE COMPETITIVENESS CHALLENGE FOR CALIFORNIA

An unknown and mildly cynical observer once stated that "reality is that which is boldly asserted and plausibly maintained!" It can be said that up until now,

**Figure 2. GDP of CA Trading Partners and Growth of CA Exports (average 2006-2008)**




California has boldly asserted the competitiveness of its economy and that the results in wealth creation have plausibly supported that claim. The standard explanations for the dynamism and growth of the California economy have now become near mantra in public policy conversations.

Apart from the sources of comparative advantage already described, California boosters like to cite an innovative and creative society which is multicultural, friendly, young, smart, innovation loving, and risk-taking. The educational system is often argued as a central institutional development that underlies these characteristics. In addition, California has had a reputation as an enlightened and forward-looking state when it comes to certain public policy issues such as pollution, education reform, transportation, taxation, and more. Business-sector leadership in high technology development, agricultural innovation, seaport and airport investment and, of course, media and entertainment are the intangibles of California business climate.

So is there a competitiveness problem? The general answer seems to be "No…for now." But what if the question is "Should California be more mindful and proactive in managing its comparative and competitive advantages?" Then the answer may well be "yes" for all of the reasons already cited. Being clear about this distinction between now and the future is especially important now. During the Great Recession, California developed one of the highest unemployment rates in the U.S., a state government with severe budget decision problems, a stagnant housing market, a decline in basic public services, and a deterioration of infrastructure. That is, all of California's problems have the potential for eroding the current competitive advantage. Therefore, it is important to understand the processes at work and the policies which might either mitigate or exacerbate the effects of simply allowing those processes to continue to unfold.

## MANAGING ADVANTAGE TO ONE'S ADVANTAGE

Countries and regions can and do develop proactive competitiveness policies which manage the process of changing comparative advantage by instituting public incentive policies. However, there is a long literature on industrial policy in the developed world which has cast some doubt on the real cost/benefit and sustainability of such policies.[11] Basically,

substituting government for the market place in picking winners and losers is at best a tie.[12] Indeed, it is argued that states which engage in ad hoc tax and subsidy competition with one another for the location of businesses are engaging in policies which foster inefficiency and which reduce welfare.[13]

But in studies of developing countries the answer seems to be different. Specifically, if a country can target a particular industry and create the conditions for that industry to grow, it may well affect comparative advantage in a way which is welfare increasing.[14] An example of this is the development of knowledge communities. The market place is unlikely to foster the creation of innovative non-profit engineering colleges and research institutions. But if a critical mass of these exist, as they do in California, then a whole host of new products and industries could appear.

In Malaysia, for example, the government decided to champion the development of a national automobile industry.[15] The Indian government, working with the major local industrial conglomerate Tata, used tax and subsidy supports for the development of a "bottom of the pyramid" car for the mass market.[16] In both cases investment in the auto industry was for the purpose of developing a skilled industrialized workforce and a complex of suppliers which could provide the preconditions for a change in comparative advantage.

In a very real sense, these governments have been engaged in picking winners and losers. Nevertheless, their industrial policy may be yielding long-term welfare benefits for their economies as a whole independent of the success or failure of particular automobile companies. Other examples include the Russian fertilizer industry, the French national champion policy in pharmaceuticals, and the Reagan administration's imposition of tariff barriers on Japanese motorcycles.[17]

However, the historical record is not always good. As in the case of individuals, it is difficult to wean a private company off the public dole if it ended up on the dole in the first place due to explicit public policy. There can be a loss of competitiveness as the pressures of market place are relaxed and the need to face risk and challenge is lessened. In the end however, a generalization of the cost/benefit analysis of government action may remain an unresolved issue. There is a logic in political rationality that often trumps economic rationality as in the cases of trade protectionism or local favors. Particular policies designed to influence competitiveness will have to be analyzed on a case-by-case basis.

The extent and final benefits of a competitiveness public policy will be debated indefinitely. Apart from the arguments of who benefits and who pays (and why), there are the inevitable arguments about opportunity cost, wasted resources, inefficiencies and the like. For every example of losses and costs, there are counterexamples.

But we note that the issue of competitiveness often arises when there is a general impression of relative decline and/or failure of a larger political economy to adjust to globalization.[18] So, while we remain skeptical about the efficacy of competitiveness policies in general, the issue is not cut and dried. Therefore, explicit competitiveness policy, even if it is a policy of non-intervention and non-action, is an important component in the portfolio of California state policies. Globalization processes of change continue relentlessly and somebody has to decide how to respond to those changes.

# COMPETITIVENESS AND THE NEED FOR A "SCORECARD APPROACH"

In the years from the late 1980s, through the dot-com era, and into the new millennium, very significant gains in both absolute productivity and in the growth rate of innovation-induced productivity contributed to the California economy and to maintenance of the state's competitiveness. Much of this productivity was due to the rise of the web and internet.[20] The rise of the information economy meant that access to new information, new contacts, and new opportunities created the need for new business models. Firms needed new competencies and new ways of doing business.

California's knowledge communities, particularly in the Bay Area, led the charge into the information age. This growth in productivity offset the loss of jobs in traditional manufacturing from outsourcing to Asian suppliers, relocation of factories out of state, and automation of other factories. In other words, the preconditions for a favorable change in comparative advantage allowed California to remain competitive in a rapidly changing world.

Today's driving force is globalization which has essentially erased the protective effects of national borders. Globalization has re-dealt the deck in terms of the location of business. This change is felt throughout in the U.S. with traditional manufacturing now accounting for less than 15% of the U.S. total output.[20] Services, construction and information now make up the larger share of economic activity in the U.S. and in California competitiveness policy concerns have shifted to a new set of issues.

The California economy continues to move to higher added value products with both physical and service components built into them. It continues to add more sophisticated services and develop more complex technologies. But the kinds of policies which reinforce these trends are themselves new, evolving, complex and often untested. Thus at the national level, competitiveness policy discussions have already turned to include a wide variety of interrelated issues relevant to the discussion in California such as:

- The continued need for large investments in research and development to promote ever more complex leading-edge innovations, e.g., nanotechnology applications to medical services, electric cars and related technology.
- The importance of flexible education policies and investments to create a more sophisticated workforce.
- Immigration reform and visa policies that affect the ability of firms and regions to attract high level international talent.
- Intellectual property protection.
- Technology transfer regimes and restrictions.
- Domestic business-government joint international programs

Given these complex global issues it is easy to see how competitiveness policy discussion of the future will have to be different. First, it will require a more sophisticated systems perspective to understand how all the various parts are interdependent and decision linked. Second, decisions will need much better information and data (e.g., improved collection, management, and dissemination) to inform and support policy decisions. Thirdly, better practices and organization designs to create a coordinated and coherent policy will require a better set of mechanisms to forge, communication and institutionalize common policies. While productivity will remain, like scoring

in a game, the most important single factor in winning, there needs to be a better balancing of economic, social, political and environmental criteria in policy decision making. Lastly, there needs to be an honest clarification of beliefs, assumptions and theory to guide policy actions in the future. An ideological approach will not do. Competitiveness is not a problem that can be addressed with one-time solutions. Rather it is a condition and state of comparative advantage factors that need to be monitored and managed constantly. In some cases, no intervention may be chosen but that decision should be explicitly stated and the rationale clearly provided. Where intervention is chosen, the choice should be made clear.

## WHAT IS THE SCORECARD APPROACH TO STATE COMPETITIVENESS POLICY?

There is a distinction between one-off solutions subsidizing a particular company or industry at taxpayer expense and creating a general environment in which California can find competitive advantage in high value added industries. To approach this issue, we reframe the discussion and negotiations of the public policy of competitiveness with the *balanced scorecard approach*. We have not originated this approach but we have adapted it for California from the approach taken by the Balanced Scorecard Institute.[21] We quote from the Institute website below:

> *"The balanced scorecard is a strategic planning and management system that is used extensively in business and industry, government, and nonprofit organizations worldwide to align business activities to the vision and strategy of the organization, improve internal and external communications, and monitor organization performance against strategic goals…*
>
> *"The balanced scorecard is a management system …that enables organizations to clarify their vision and strategy and translate them into action … When fully deployed, the balanced scorecard transforms strategic planning from an academic exercise into the nerve center of an enterprise.*
>
> *"The balanced scorecard has evolved from its early use as a simple performance measurement framework to a full strategic planning and management system… It provides a framework that not only provides performance measurements, but helps planners identify what should be done and measured. It enables executives to truly execute their strategies."*

Within this somewhat opaque jargon is a basic message. Determine your objectives. Pick out the key variables that are in play and look at the effects of a decision on each objective. Then balance those effects. Up to the present, ad hoc and reactive policies common to most state legislatures tend to follow the old and bad wisdom that if you don't know where you are going, any road will get you there! California needs to know where it is going in this challenge to its competitiveness and any road will not get it there.

While the scorecard approach was first applied to business, its value as a management tool has become apparent in government as well.[22] It was originally introduced into the Policy Planning and Budgeting System by the Kennedy Administration. Subsequently, formal systems of management have been used and developed by successive administrations. For example, Jeffrey Zients, President Obama's Chief Performance Officer and Deputy Office of Management and Budget Director, has adopted the scorecard approach to tackle budget deficit issues. Zients' model—which balances out decisions about, say, budget or trade deficits—includes six "High Performing Government" themes:

**Figure 3. Comparing Strategy in Private and Public-Sector Organizations**

| Strategic Feature | Private Sector | Public Sector |
|---|---|---|
| General Strategic Goal | Competitiveness | Mission Effectiveness |
| General Financial Goals | Profit; Growth; Market Share | Cost Reduction; Efficiency |
| Values | Innovation; Creativity; Good Will; Recognition | Accountability To Public; Integrity; Fairness |
| Desired Outcome | Customer Satisfaction | Customer Satisfaction |
| Stakeholders | Stockholders; Owners; Market | Taxpayers; Inspectors; Legislators |
| Budget Priorities Defined By: | Customer Demand | Leadership; Legislators; Planners |
| Justification For Secrecy | Protection Intellectual Capital; Proprietary Knowledge | National Security |
| Key Success Factors | Growth Rate; Earnings; Market Share | Best Management Practices |
| | Uniqueness | Sameness; Economies Of Scale |
| | Advanced Technology | Standardized Technology |

1. Ensuring responsible spending of Recovery Act (stimulus) Funds

2. Putting performance first: Instituting a New Performance Improvement and Analysis Framework

3. Transforming the federal workforce

4. Managing across sectors

5. Reforming federal contracting and acquisition

6. Transparency, technology, and participatory democracy[23]

By specifically calling out each of these themes with respect to each issue in the balanced scorecard, the Obama Administration seeks to give visibility to important multivariate values in the decision process. Such an approach to competitiveness policy in California will make the policy choices clearer and the goals of policy more transparent.

To begin, a balanced scorecard to state competitiveness policy has a first serious obstacle; there is an inevitable difference between the public and private sectors over the question of competitiveness. The difference resides in expectations, interests, incentives, controls, and outcomes of any policy. Private corporations have private interests and public agencies have public interests. In both cases, each of these perspectives must take into account of the other side's interests. But the differences remain as seen in **Figure 3**, taken from the BSI website.

Any balanced scorecard for competitiveness policy in California must reconcile these differences early and come up with a set of common acceptable, measurable, and reachable criteria for performance. In addition to the private–public nexus issue, the scorecard approach is a management philosophy and practice that focuses on both policy formulation as well as policy implementation through programs. In this case we are looking only at the policy formulation process in a competitiveness strategy. The implementation of that strategy would require a further analysis of actual California government institutions and practices to test their alignment and fit with policy expectations and mandates.

**Figure 4. California Competitiveness Balanced Scorecard**

1. **Advantage**
   The scorecard must focus on specific advantages that are unique, differentiable, and defensible. Developing new advantages, protecting existing advantages, and adapting past advantages must be initial conditions.

2. **Resources**
   The scorecard must focus on supporting resources (quality, quantity, availability, access, and cost benefits) for competitiveness improvement. Without appropriate and sufficient resources, a policy is merely a hollow statement of intentions. Commitments must be made; accountability controls on the use of resources must be set up.

3. **Favorable Environment and Positive Context Factors**
   The scorecard must identify those elements in the institutional environment that must be supportive or which are hindering a policy effort.

4. **Goals and strategy**
   If the scorecard strategy does not contain new good ideas, clear goals and a method to achieve them, competitiveness improvements will not result.

5. **Leadership and Teamwork**
   This element is perhaps the most important. There must be a champion behind a strategy. The scorecard strategy requires top leadership, a person or persons with vision, perspective, skills, experience, endurance, patience and general management competency.

6. **Organization system**
   Work gets done via organized human effort. The effectiveness of the organization is seen in the configuration of its structures, processes, and culture. Effective organizations are characterized by highly motivated people, preparedness, responsiveness, flexibility, foresight, and a systems perspective.

7. **Execution and performance edge**
   The scorecard strategy requires a focus on execution of policy. The statements of policy purposes, values and mission are only a starting point. The balanced scorecard ties intentions to effective execution and the development of a sustainable performance edge in the practices of the organizations in charge of policy.

8. **Relationships**
   The scorecard strategy is a systemic policy that requires the coordination with, and cooperation of, many organizations. Clarification of relationships and identification of key success factors is required.

# ELEMENTS IN THE CALIFORNIA COMPETITIVENESS BALANCED SCORECARD

In following the logic of the balanced scorecard, there are two initial conditions. First, a competiveness scorecard must provide a balanced metric beyond single financial measures alone (such as state budget overruns or trade deficits). Secondly, there needs to be an overall theme that captures and drives the competitiveness policy. For example, California might adopt Growth-Through-Global-Competitiveness as a theme. Such themes capture the larger mission/objectives of a policy and point to the kinds of goals that need to be defined.

If you ask the question, "How do you make X a competitive entity?"—whether X is a company, an economy, or a sports team—you will find that the answer lies in a fundamental set of elements that seem to enter into all competitiveness strategies. We suggest that the elements of a competitiveness policy shown on **Figure 4** can be key aspects part of the proposed California Competitiveness Balanced Scorecard.

The eight elements in the California Competitiveness Balanced Scorecard , like the six "High Performing Government " themes, serve as key areas of policy discussion and emphasis. They also provide metrics to measure achievement of these goals for explicit policy evaluation. Up to this point, California policy on competitiveness might be characterized as disjointed incrementalism where a series of ad hoc decisions fail to achieve objectives in an efficient and direct manner.[24] In any one year, some industries

receive subsidies, e.g., film making, while others do not. Since educational program and infrastructure spending often responds to short-term budgetary objectives , they end up wasting resources as earlier plans get easily abandoned as educators are required to respond to new and changing politically motivated goals and objectives. In yet another case, local entities compete for firms to locate within their boundaries through tax breaks and other devices without regional or statewide considerations. Thus each city or region is open to a type of "blackmail" as the target organization plays them against one another and continues to up the ante of the bidder. The point here is that piece meal, one by one, ad hoc and reactive policy making is an increasingly risky practice for a state that wants to manage its advantages better for increased competitiveness.

## CONCLUDING REMARKS

In this chapter, we have shown that in an immediate sense, California is still demonstrating competitiveness in international markets. The state's exports indicate a growth in market shares for its products. We noted that some of the assets of California—location and weather, for example—are inherent characteristics of comparative advantage. But other assets that have contributed to current competitiveness involve past investments in physical and educational infrastructure. Other states, regions, and nations can make such investments and erode the advantages that California developed in the past. Globalization continues to change the dynamics of international competition and no economy can be complacent in the face of changing comparative advantages and the rise of new competitors.

California has a political economy, i.e., mechanisms by which public policies that affect the economy are made. We have suggested that future competitiveness should be a major concern of public policy, even if in some cases the best decision is determined to be no public intervention. We suggest adapting an approach to the state's public policy taken from the business literature that involves explicit listing of objectives and a balancing approach across those objectives. The California Competitiveness Balanced Scorecard we propose is a framework for such public policy.

Will future governors and legislators take a more systemic and long-term view of state competitiveness policy? In the end we remain optimistic that out of the pressures of the Great Recession a better approach will emerge. But we are concerned that current *ad hoc* policymaking may be leaving California to suffer a gradual erosion of its past economic advantages.

# END NOTES

1 Nickelsburg is Senior Economist and Lecturer, UCLA Anderson School of Management; Spich is Sr. Lecturer in the Global Economics and Management faculty group and Faculty Program Director of the Center for International Business Education and Research (CIBER) at the UCLA Anderson School of Management.

2 Financial Times, August 19, 2010 p. 21.

3 A competitiveness policy can address a wide range of issues including trade, investment, taxation, subsidy and support, education, political decision making, infrastructure and even diplomacy. In this paper the focus is on those policies that support export trade and investment in that trade.

4 David Ricardo, *On the Principles of Political Economy and Taxation*, London, 1817.

5 The same concepts apply when we are talking about trade and competition between, say, California and Texas.

6 Traditional analysis emphasizes price advantages which are still the dominant factor in determining trade transactions. Increasingly though, with more sophisticated products, product and firm brand reputation as determined by quality, service and product life span have entered into the customer purchase decision and thus trade possibilities.

7 Richard P. Rumelt, "What in the World is Competitive Advantage," Policy Working Paper 2003-105, UCLA Anderson School of Management, 2003.

8 Ellen Haynak, "Paying For Infrastructure: California's Choices," Public Policy Institute of California, January, 2009. Joel Kotkin, "The Golden State's War on Itself," City Journal, Summer 2010. Kevin Starr, "Golden Dreams: California in the Age of Abundance 1950-1963," Oxford University Press, 2009. Kevin Starr, "Material Dreams: Southern California Through the 1920's," Oxford University Press, 1990.

9 State Higher Education Profiles, University of California Office of the President, http://ucfuture.universityofcalifornia.edu/documents/state_heprofiles.pdf

10 This is why the California budget crisis that developed in 2008 and beyond is of fundamental importance. As was pointed out by Governor Schwarzenegger in his January 2010 State of the State address, that California would consider spending more on prisons than on higher education was an economic absurdity.

11 Adams, F. Gerard and Lawrence R. Klein (eds.), *Industrial Policy for Growth and Competitiveness*, Wharton Econometric Studies, Volumes I and II, Lexington Books, D.C. Heath and Company, 1983.

12 For a good summary of the theoretical and empirical evidence see: David Spector , Antoine Chapsel, and Laurent Eymard, "Industrial Policy, Competition Policy, and National Champions," Global Forum on Competition, OECD, 2009.

13 Peter D. Enrich, "Saving the States from Themselves: Commerce Clause Constraints on State Tax Incentives for Business," *Harvard Law Review*, 1996. Melvin L. Burstein and Arthur J. Rolnick, "Congress Should End the Economic War Among The States," Annual Report, Federal Reserve Bank of Minneapolis, 1994.

14 Stephen Redding, "Dynamic Comparative Advantage and the Welfare Effects of Trade," *Oxford Economic Papers*, (51), 1999. Jerry Nickelsburg, "Dynamic Incentive Structures and Industrial Policy," *Journal of International Economic Integration*, 1987. Debraj Ray, "Uneven Growth, A Framework for Research In Development Economics," *Journal of Economic Perspectives*, 2010.

15 See http://www.eautoportal.com/eap/data/country/country.asp?show=Malaysia

16 See http://online.wsj.com/article/SB123563219509880187.html

**17** Reid, Peter C. *Well Made in America: Lessons From Harley-Davidson on Being the Best*, McGraw Hill: New York 1990; Financial Times, August 9, 2010, p. 1, “Russian oligarch to form national champion in fertilizer industry”; Syed Tariq Anwar, (2008) “Creating a national champion or a global pharmaceutical company: a tale of French connection”, *Journal of Business & Industrial Marketing*, Vol. 23, Issue 8, pp.586-596.

**18** Industrial and activist intervention policies may, in themselves, be an indicator of decline in the ability to compete.

**19** Productivity gains were achieved in scale of reach, overcoming barriers of geography, simultaneous transactions, instantaneity and connectivity of transacting partners. All of which translated into lower costs.

**20** In addition, there is some concern about the loss of industrial skills in the American workforce, known as de-skilling.

**21** http://www.balancedscorecard.org/BSCResources/AbouttheBalancedScorecard/tabid/55/Default.aspx

**22** http://www.balancedscorecard.org/BSCResources/GovernmentPerformance/tabid/377/Default.aspx

**23** As noted in the BSI website, “The key metric for government (or nonprofit) performance, therefore, is not financial in nature, but rather *mission effectiveness*. But mission effectiveness is not a definite and static thing. Usually, an agency has a rather broad general mission, which incorporates many specific sub-missions or departmental missions within it. At any given time, some departmental missions may be more important than others for the needs of the country. The selection of the departmental mission priorities is an ongoing strategic planning responsibility.

**24** Braybrooke, David and Charles E. Lindblom, *A Strategy of Decision:Policy Evaluation as a Social Process; Free Press, Macmillan Publishing Co:New York*, 1970. Braybrooke and Lindblom invented the term “disjointed incrementalism” in describing quasi-rational decision making in public policy.

8

# HOUDINI TAX REFORM: CAN CALIFORNIA ESCAPE ITS FISCAL STRAIGHTJACKET?

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# 8

*"…The easiest way to attract a crowd is to let it be known that at a given time and a given place someone is going to attempt something that in the event of failure will mean sudden death."*

—Harry Houdini (1920)[1]

At the final meeting of the Commission on the Twenty-first Century Economy (COTCE)—the bipartisan commission established by California lawmakers to consider changes to the state's tax system—a large crowd gathered to hear Chairman Gerald Parsky announce the Commission's recommendations for reform. Topping the Commission's wish list were proposals to (i) reduce and restructure the personal income tax, (ii) repeal the state portion of the retail sales tax, (iii) repeal the state corporate income tax, and (iv) enact a new "business net receipts tax" (BNRT) to replace the revenue lost as a result of items (i)-(iii). Despite securing the support of nine of the fourteen COTCE Commissioners, as well as a pledge from Governor Schwarzenegger that he would "sign it immediately," the COTCE plan was widely viewed as "dead on arrival."[2]

Public commentary on the plan took on a funereal tone. Labor leader Art Pulaski predicted that the COTCE proposals would "entomb California in perpetual recession." California Chamber of Commerce President Alan Zaremberg tagged the plan as "fatally flawed." Both the California Senate and Assembly convened hearings to consider the COTCE proposals, but the plan never became law and was instead quietly buried in committee.

Why is tax reform in California so hard? What accounts for the demise of the Parsky Commission's reform proposals? One possibility, suggested by Governor Schwarzenegger, is that entrenched special interests killed the reform effort. "As expected," the Governor noted, "the Commission's proposals have been met with howling protests from an army of

lobbyists and special interests, left and right, who rely on the status quo."[3] In calling out lobbyists for both "left and right" the Governor seems to be referring to the views expressed by Pulaski and Zaremberg noted above. Both business and labor benefit from the current tax system, the argument goes, so naturally they'll make every effort to kill any proposal for meaningful reform.

Another possibility, suggested by political journalist Dan Walters, is that "everyone has a different take on how taxes should be made fairer, more relevant and easier to administer. … That's why, for decades, tax reform has been an issue about which there is endless discussion but no action." Under this view, the failure of tax reform is more a function of basic philosophical differences. Everyone agrees that tax reform is needed; it's just that they differ on *how* the tax system should be changed.

There is some truth to both of these explanations. Certainly those who stand to lose from any sort of policy reform will make efforts to preserve the status quo. And, of course, philosophical differences about taxes have been frustrating tax reform for about as long as taxes have been in existence. But these standard accounts of tax reform's failure don't quite capture the full complexity of the problem California faces in designing a new tax system.

In this chapter, I draw on the experience of the recent Parsky tax reform commission in order to highlight some of the main obstacles to fundamental tax reform in California. As explained further below, anyone who wishes to change the state's tax system confronts a task not unlike the notorious Water Torture Cell escape first performed by Harry Houdini in 1913. Like the famed escapologist, California has been locked in stocks, suspended in mid-air from its ankles, and lowered into a glass tank overflowing with water. Political and philosophical differences no doubt hinder tax reform, as they almost always do. But those wishing to escape the status quo must also contend with a legal apparatus that fundamentally constrains their ability to bridge those differences.

This rickety contraption, which itself is long overdue for reform, consists of state constitutional law (principally, though not exclusively, Proposition 13), federal constitutional law (i.e., the U.S. Supreme Court's dormant commerce clause jurisprudence), and federal statutory law (both federal tax law and P.L. 86-272). For better or for worse, these basic legal parameters—over which state legislators have little or no control—severely limit California's freedom of movement when it comes to reforming its tax system.

Recommendations of the Parsky Commission can only be understood in the context of these basic restrictions. In particular, the Commission's centerpiece reform, the "business net receipts tax," is best viewed not as a "bold" innovation, as journalist George Skelton suggested. Rather, it should be viewed as a symptom of how tightly bound the state is by these legal constraints.[4]

The basic concept underlying the BNRT—i.e., the idea of a subnational subtraction-method value-added tax apportioned by firms' gross receipts—has never surfaced in the vast literature on state and local tax policy.[5] It is perhaps no surprise, therefore, that the BNRT proposal suffers from several key design flaws militating against its adoption. Limited by the constraints of state and federal law, the Parsky Commission backed into a proposal with deep imperfections. This analysis suggests that if California truly wishes to "establish a 21st century tax structure that fits with the state's 21st century economy" it must first seek to remove (or at least loosen) the basic legal restrictions that derailed the Parsky Commission's reform efforts. In the absence of such changes, California tax reform must be resignedly incremental in its scope and ambition.

The remainder of this chapter is organized into three parts. Part I provides a description of the internal constraints on the Parsky Commission's proposals, emphasizing several key decisions the Commission made to limit the scope of its agenda. Part II turns to external constraints, highlighting the relevant provisions of federal constitutional and statutory law that limit and influence any state's effort to reform its tax system. Part III describes the Commission's recommendations and explains the chief shortcomings of the BNRT proposal. The key argument is that, despite its many flaws, the BNRT was a logical outgrowth of the various internal and external constraints the Commission faced. Part IV offers a brief conclusion as well as some preliminary suggestions for a new framework for thinking about California tax reform.

# I.INTERNAL CONSTRAINTS ON THE COTCE TAX REFORM EFFORT

The Parsky Commission was handed a seemingly impossible task. In the Executive Order establishing the Commission, Governor Schwarzenegger requested recommendations for changes to the state's tax laws that would (a) establish a 21st century tax structure that fits with the state's 21st century economy, (b) stabilize state revenues and reduce volatility, (c) promote long-term economic prosperity, (d) improve California's competitiveness, (e) reflect principles of sound tax policy, including simplicity, competitiveness, efficiency, predictability, stability and ease of compliance and administration, and (f) ensure that the tax structure is fair and equitable.[6]

Given the generality of these objectives, the Governor's Executive Order might have been interpreted to support many different tax reform projects—from the most minor technical fixes to a grand reworking of the entire tax structure. However, early on in its deliberations, the Parsky Commission made certain key decisions regarding the scope of their mandate. These decisions, which can be thought of as "internal constraints" on the Commission's work, laid the groundwork for their ultimate recommendations, in particular the controversial BNRT proposal.

## A. THE META-GOAL OF REDUCING TAX VOLATILITY

First, although the Executive Order gave no relative weighting to the several goals it expressed, it was apparent from the first COTCE hearings held in January 2009 that item (b), concerning the need to "stabilize state revenues and reduce volatility," would be the paramount objective of the Commission's reform recommendations.[7] While the other goals were certainly discussed and debated, the overriding focus of the Commission's work was the question of tax volatility. That concern was not misplaced.

Since the late 1970s, variability in the state's tax receipts—measured by the short-term elasticity of key revenue sources with respect to personal income—has exceeded cyclical changes in the underlying economy. The result is a roller-coaster of tax receipts for the state's General Fund.[8] The consequent boom-bust dynamic has become a familiar feature of California public finance—boom year lawmakers seize upon boom year revenues to fund boom year projects (e.g., smaller class sizes, reductions in the vehicle license fee) that ultimately become unsustainable when the boom turns to bust.

It is tempting to think that boom year revenues should be set aside in a "rainy day" fund in anticipation of subsequent revenue shortfalls. In fact, California already does this—via the "Budget Stabilization Account" (BSA) established by Proposition 58 in

2004.[9] Unfortunately, however, the effect of the state's current BSA is quite limited. Proposition 1A, which would have increased the size of the account from 5 percent to 12.5 percent of the General Fund, was defeated by California voters in May 2009. The results of the May 2009 election added a sense of urgency to the Commission's efforts to deal with the revenue volatility problem through modifications to the revenue structure rather than through changes in the state's reserve policy.

Several Commissioners, including Chairman Gerald Parsky, seemed to assume that a reduction in revenue volatility would require a reduction in the overall progressivity of the state tax burden.[10] As discussed further below, there are certain policy options that would enable the state to reduce revenue volatility without significantly altering the distribution of the tax burden. Nevertheless, Commission deliberations from January 2009 onward repeatedly made reference to a tradeoff between revenue volatility and the overall progressivity of the tax system. As the final report put it, "due to its highly progressive nature, which taxes high-earners at a higher rate than lower or middle income taxpayers, revenues soar far beyond average income growth in good times and collapse in bad times."[11]

Not surprisingly, the link between progressivity and volatility is mostly a function of the state's reliance on the personal income tax (PIT) and the corporate income tax (CIT). For the year 2006, for example, the top one percent of income earners accounted for 48 percent of all PIT revenues but only 25 percent of adjusted gross income.[12] Moreover, as the report noted, inclusion in the PIT tax base of income from capital gains and stock options further exacerbates the problem of revenue volatility. Those items tend to peak in boom years and plummet in bust years.

### B. THE POLITICS OF (NOT) TAXING SERVICES

Second, at some point in its deliberations the Commission determined that an extension of the retail sales tax to cover services was not politically possible. Since its inception during the Great Depression, the state sales tax has been focused principally on the retail sale of tangible personal property. During the second half of the 20th century, as the U.S. economy shifted from industrial production to the provision of services, the idea of taxing only the consumption of tangible personal property became increasingly outdated.[13]

For decades, state tax reformers have sought to "modernize" state retail sales taxes by expanding the base to cover services. For the most part, these efforts have not been successful. The most ambitious effort to tax services was an effort made in Florida in the late 1980s. But having enacted a general sales tax on services in mid-1987, the Florida legislature voted to repeal the expansion of the base by December of the same year.[14]

In California, Governor Schwarzenegger has at various points endorsed the idea of taxing services, including a proposal to tax selective services (e.g. vehicle repairs, veterinarian services, golfing fees) as part of his 2009-2010 budget submission.[15] These proposals prompted predictable opposition from body shops, golfers, and pet owners, with the result that proposal was dropped in the final budget agreed to in February 2009. That same month, the Parsky Commission heard testimony from several witnesses regarding the expansion of the retail sales tax to include services, though the issue was not given sustained attention after that meeting.

It appears that the Commission decided that extending the sales tax to services was a political non-starter. This decision (in combination with the federal constitutional constraints discussed below), effectively ruled out the possibility of any sort of broad-based sales tax reform. Thus, it appears that, as far as the Commission was

concerned, any effort to increase the state's reliance on broad-based consumption taxes would require looking beyond the retail sales tax (RST).

### C. THE POLITICAL IMPERATIVE OF REVENUE NEUTRALITY

Third, the Commission determined that it would submit to the legislature a package of tax reforms that could be scored as "revenue neutral." In other words, the revised tax laws would be designed to generate approximately the same amount of revenue as current law. Revenue neutrality was not among the goals listed in the Executive Order, although Governor Schwarzenegger did raise the issue in the press conference held to announce the establishment of the commission.[16]

Revenue neutrality as a constraint is a perfectly legitimate starting point for debates over tax reform, especially insofar as it separates out the more politically sensitive question of the proper size of government. But a decision to start from neutrality has consequences. Most obviously, requiring a revenue-neutral package necessarily had the effect of requiring the Commission to replace any revenue that would be lost as a result of revenue-reducing changes it recommended. In combination with the Commission's heavy emphasis on reducing tax volatility, as well as its assumption that progressivity begets volatility, the revenue neutrality constraint virtually guaranteed that the Commission would advance a set of proposals shifting the overall tax burden away from high-income households to low- and middle-income households.[17]

Of course, the decision to recommend only revenue neutral changes in the law also had an important legal dimension. Because a revenue-neutral package would not be a "change in state taxes enacted for the purpose of increasing revenues," it would not need the approval of a two-thirds majority of both houses of the Legislature as required by Section 3 of Article XIIIA of the state Constitution. Given the Governor's announced commitment to approving whatever package of reforms the Commission endorsed, all that would be required to convert the final recommendations into law would be approval by a majority of both houses. Thus, the Commission's self-imposed revenue-neutrality not only served to neutralize any arguments about the size of government, but was also meant to facilitate legislative action on the final report.

### D. STATUTORY REFORM ONLY

Fourth, with one exception relating to a proposal to establish a more robust rainy day reserve fund, the Commission determined that its recommendations should only require changes in *statutory* law. It is hard to know with certainty why the Commission took this position, given that so much of California's tax law is set forth in the state Constitution. Most likely, it was determined that constitutional reform was either too ambitious or politically unrealistic.

In combination with the revenue-neutrality constraint, the decision to focus exclusively on statutory changes minimized the obstacles to enactment. Unlike constitutional changes, revenue-neutral statutory reforms could be enacted via agreement between the Republican Governor and the Democratic majority in both houses. The Republican minority in the legislature could be bypassed entirely.

As with the revenue neutrality constraint, the Commission's decision to limit its recommendations to statutory reforms is understandable. But it also had consequences. Had the Commission taken on constitutional reform, its recommendations almost certainly would have included proposed amendments of Proposition 13 of 1978. But Prop 13 is widely regarded as the "third rail" of California politics.[18] Whatever the reason, the decision to focus exclusively on statutory changes very substantially limited the range of policy options available to the Commission. Any change to the property tax was rendered off-

limits by this decision, as were certain modifications regarding the taxing powers of cities, counties, and school districts.

### E. STATE TAX REFORM ONLY

Finally, closely related to the Commission's decision to consider only statutory reforms was its decision to focus its reform efforts on the three main sources of revenue for the state General Fund—i.e., the retail sales tax, the personal income tax, and the corporate income tax. Roughly 95 percent of state General Fund revenue comes from these three taxes. Thus, at first blush, it might have appeared that, by focusing on these three taxes, the Commission could get at the meat of the matter.

## THE STATE VS. LOCAL DISTINCTION

Significantly, however, more than one-third of the combined state-local tax burden in California is attributable to *local* taxes. These taxes include, most importantly, roughly $50 billion in property taxes and $13 billion in local sales taxes.[19] Moreover, as a matter of economic substance, rather than mere labeling, it is not clear why these taxes shouldn't also be considered "state" taxes. Looked at as state taxes, they would be just as deserving of the Commission's reform efforts as any of the "Big 3" General Fund revenue sources.

The rate and base of the property tax are specified by state law—not by local ordinance. Moreover, under the terms of Proposition 13, the allocation of property tax revenues among local governments is determined by the state legislature. These characteristics of California's property tax suggest that it is best viewed not as a local tax, but rather as a state tax coupled with a system of state grants to local governments. Under this view, the property tax deserves equal standing alongside state income and sales taxes, as properly within the purview of a commission charged with considering changes to *state* taxes.

Similarly, the "local" sales tax in California is also a creature of state law. The basic authorizing legislation for local sales taxes is a state statute (i.e., the Bradley-Burns Uniform Local Sales and Use Tax Law) and it is state law that determines which jurisdiction is entitled to revenues attributable to taxable sales (i.e., the situs rule). Again, therefore, the supposedly "local" sales tax appears to be local in name only.

In many respects, California's system of local sales taxes is more accurately described as a supplemental state tax coupled with state grants directed to jurisdictions where the sale occurs. With regard to both property and sales taxes, however, significant reform would likely require constitutional amendments. Thus, it appears that it was the Commission's aversion to constitutional reforms that led it to take these nominally "local" taxes off the table.

The Commission's decision not to take on constitutional reform significantly narrowed the range of policy options available to accomplish its objectives. For example, had the Commission been open to constitutional reforms, it could have pursued an idea raised by UCLA economist Jerry Nickelsburg during his February 2009 testimony before the commission. Nickelsburg presented a graph showing that, as compared to all other states, California experienced the highest degree of tax variability, largely as a result of two factors—(1) the percentage of tax revenue from income tax collections, and (2) the progressivity of the state's personal income tax.[20] The resulting swings in general fund revenue were, perhaps not surprisingly, strongly correlated with moments of fiscal stress over the post-World War II era.

Notably, however, Nickelsburg's very next slide showed that California was among the *lowest* of the states in terms of the variability of property taxes for

the period from 1992-2006.[21] Only eight other states showed lower property tax variability during that period. Put differently, as compared to other states, California has one of the most volatile personal income taxes and one of the least volatile property taxes.

These data prompted Nickelsburg to raise in his testimony before the Commission a policy change involving a (1) 40 percent reduction in personal income tax rates, and (2) a 0.7 percentage point increase in the property tax rate (but keeping all other Prop 13 base restrictions in place). Although Nickelsberg did not expressly endorse this proposal, he did note that the principal effect would be that "over time, you get the same revenue. You have just spread that revenue in a more orderly way."[22] In other words, by embracing a "statutory reform only" constraint, the Commission effectively declared off-limits a broader range of revenue-neutral reforms that would have reduced overall tax volatility.

## THE SPLIT ROLL

Another policy option, had the Commission not ruled off-limits constitutional reform, was some sort of "split-roll" regime for the California property tax. Under a split-roll regime, residential real property would be taxed differently than non-residential property (principally commercial and industrial property). Although the split-roll concept encompasses many possible reforms, typically the term is used to refer to the policy of imposing a heavier tax burden on non-residential property, either by taxing such property at a higher rate, using different rules regarding the definition of the tax base, or both.

In hearings before the Commission in February 2009, UC Davis economist Steven Sheffrin identified several virtues of moving toward a split-roll property tax, including (1) increasing the share of the tax base coming from property taxes, long identified as a more stable source of revenue, (2) providing revenue that could finance reductions in more volatile taxes, such as capital gains taxes, (3) minimal distortions on the cost of capital, and (4) enhanced progressivity, given that the burden of increased property taxes for owners of commercial and industrial property would likely burden higher-income taxpayers.

Professor Sheffrin's testimony emphasized that taxing non-residential property at fair market value, rather than at its acquisition value (as is currently the case under Proposition 13), was tantamount to imposing a tax on post-1978 land appreciation and thus "very close to the economists ideal of non-distorting taxes."[23] These insights were confirmed by testimony offered by Sacramento State economist Terri Sexton.[24] Again, as with the Nickelsburg suggestion of swapping out higher property taxes for a proportional reduction in personal income taxes, it appeared that this policy reform directly addressed several of the main concerns outlined in the Governor's Executive Order—volatility, efficiency, fairness, etc. Nevertheless, the Commission determined that the idea of a split-roll property tax was, as Commissioner Chris Edley put it, "a total nonstarter." "I mean, forget first base," Edley noted, "it didn't even get out of the batter's box."[25]

In summary, the task the Commission set for itself was to recommend a package of statutory changes that would substantially reduce state tax volatility while raising approximately the same amount of revenue as current law. Given the Commission's assumption that reduced volatility would *necessarily* involve reducing the state's reliance on the more progressive components of the taxes (particularly the personal and corporate income taxes), the outcome seemed almost preordained. Reduced reliance on the income tax would require increased reliance on some alternative revenue source, most likely a broad-based household consumption tax.

However, the likelihood that the retail sales tax could serve as the vehicle for this shift was reduced by the Commission's decision to accept the political verdict rendered in February 2009 on the Governor's proposal to modestly tend the reach of the RST to certain services. These considerations formed the basic logic underlying what eventually became the Commission's recommendation for the "business net receipts tax." Understanding the form the BNRT would ultimately take, however, requires a brief discussion of a second set of *external* constraints on the reform process.

# II. EXTERNAL CONSTRAINTS ON THE COTCE TAX REFORM EFFORT

Beyond the decisions discussed above, the Parsky Commission also faced a range of external constraints on its reform efforts. By "external" I simply mean constraints over which the Commission had no control.[26] The most obvious source of external constraints is federal law.

By virtue of the Supremacy Clause of the U.S. Constitution, California law must comply with all relevant federal constitutional and statutory limitations.[27] In addition, because Article I of the Constitution gives Congress plenary power to regulate interstate commerce, any California tax law that, in the opinion of the U.S. Supreme Court, has the effect of regulating interstate may be struck down as a violation of the so-called "dormant" Commerce Clause.[28] Finally, certain federal statutes—most notably the Internal Revenue Code—have the effect of favoring certain types of state and local taxes over other types, a consideration that also influences the design of state tax systems. In crafting its recommendations, the Parsky Commission had to confront this regime of federal restrictions and limitations on state tax law.

### A. FEDERAL CONSTITUTIONAL CONSTRAINTS—THE DORMANT COMMERCE CLAUSE

The first and most obvious federal constitutional constraint on the Commission's reform recommendations is the U.S. Supreme Court's decision in *Quill Corporation v. North Dakota*.[29] This is the decision that prevents states from imposing a use tax collection obligation on vendors without a physical presence in the taxing state. That may sound like an arcane legal rule, especially given the fact that states collect a miniscule amount of revenue from the "use tax." In fact, however, the *Quill* decision is at the heart of the long-term structural demise of the retail sales tax, upon which most states have relied since the mid-1930s.

## THE REACH OF THE SALES TAX

Although *Quill* itself is a 1992 decision, the basic groundwork for the decision was laid out in pair of opinions issued nearly a half-century earlier. In May 1944, the Supreme Court determined that a state could not impose a "sales tax" on transactions that occurred out-of-state, even if the item purchased was later used in the taxing state.[30] However, in a decision issued on the same day the Court blessed the imposition of a "use tax" by the destination state, with the result that states began use taxes that would apply to the consumption of goods purchased out-of-state.[31]

These two decisions established the basic framework for designing subnational consumption taxes. Levies labeled "sales" taxes would apply to items purchased in-state, while "use" taxes would apply to items

purchased out-of-state but consumed in-state. The Court's opinions left open the question of whether a state could impose on the out-of-state vendor an obligation to collect and remit the tax similar to the obligation typically imposed on in-state retailers.

That question was addressed in the 1967 case of *National Bellas Hess*, in which the Supreme Court declared that the imposition of a use tax collection obligation on out-of-state vendors would violate both the Due Process Clause and the Commerce Clause in situations where the vendor had no physical presence in the state imposing the obligation.[32] A quarter-century later, in *Quill*, the Supreme Court overruled the Due Process holding of *National Bellas Hess*, but upheld its Commerce Clause holding. The effect of the Court's *Quill* decision was to continue the rule of *National Bellas Hess*, but to allow Congress to craft a different rule if it chose to do so. Congress has not yet acted on this invitation.

## E-COMMERCE AS THE BENEFICIARY

So long as these federal constitutional restrictions on the design of state sales/use taxes remain in place, it is extremely unlikely that the RST will ever become the sort of broad-based consumption tax that various tax reformers have advocated over the years. Under the reformer's consumption tax ideal, the tax would apply to all retail household consumption, regardless of whether the goods (or services) were purchased in-state or out-of-state. *Quill* frustrates this outcome by carving out a de facto exemption for cross-border sales, which (partly *because* of the exemption) occupy an ever larger share of total household consumption. Fifty years ago, this meant that mail-order firms enjoyed a tax-free haven, unencumbered by the sales tax obligations imposed on local bricks-and-mortar firms. But, of course, the development of the internet and the rise of e-commerce has come to be the true beneficiary of this special regime. From the perspective of the state tax reformer, including the Parsky Commission, *Quill* represents a significant obstacle to reforming the sales/use tax. This is not to suggest that the failure of the sales/use tax to reach cross-border commerce is the only shortcoming of the tax. Various other flaws, including the taxation of business inputs and the failure to include most retail services in the RST base, also deserve to be addressed. Nevertheless, for those analysts confronting the task of reforming a state's tax system, the *Quill* issue understandably prompts consideration of alternative taxes that (at least arguably) are not subject to the *Quill* limitation. This is part of the reason why states such as Ohio and Michigan have adopted modified gross receipts taxes—the "Commercial Activities Tax" (CAT) in the case of Ohio and the "Michigan Business Tax" (MBT) in Michigan.

## ECONOMIC NEXUS

Both of these taxes incorporate "economic nexus" provisions that allow the state to tax out-of-state firms that lack a physical presence in the state but meet some statutorily specified level of economic activity in the state.[33] These states (and several others) have taken the position that the *Quill* limitation applies only to the retail sales tax and thus does not prevent them from taxing firms through these other types of levies.[34] In Ohio, litigation is currently underway against L.L. Bean, which is challenging its CAT assessment based on the Supreme Court's holding in *Quill*.[35]

# ALTERNATIVES TO THE SALES TAX

The bottom line effect of *Quill* is that California is constitutionally prohibited from extending its sales/use tax to cross-border transactions involving retailers with no physical presence in the state; however, it is possible, though by no means certain, that some alternative tax—perhaps modeled on the Ohio CAT or the Michigan MBT—could be applied to such retailers consistent with the *Quill* holding. In other words, in order to increase the chances of escaping the clutches of *Quill*, the state tax reformer might understandably opt to abandon the RST altogether in favor of some sort of tax on the receipts of firms selling into the state.

The path chosen by Ohio, Michigan, and certain other states has been to adopt firm-level business taxes where the base of the tax is determined by reference to a firm's gross receipts.[36] As attractive as this strategy may seem from a legal perspective, there are sound reasons to avoid the adoption of gross receipt taxes. In many ways, these new state business taxes are reminiscent of the old-style European "turnover taxes" that preceded the widespread adoption of value-added taxes.[37]

Those taxes were widely criticized for the inefficiencies they produced as a result of imposing a "cascading" tax liability on firms selling goods or services to other firms. Most tax policy analysts agree that gross receipts taxes should be avoided, in part because of the pyramiding of tax liabilities in business-to-business transactions and the corresponding incentive for vertical integration. In an attempt to avoid these problems, the Parsky Commission incorporated in the BNRT a deduction for amounts paid to other firms. However, this feature of the tax prompted concerns that the proposal might bump into a different federal constraint—i.e., the federal statutory limitations on "net income" taxes set forth in P.L. 86-272.

### B. FEDERAL STATUTORY CONSTRAINTS —P.L. 86-272

One of the hat tricks the Parsky Commission would need to pull off for the BNRT to work was to make sure that (1) the tax would not be considered a sales tax and thus subject to the Supreme Court's holding in *Quill*, and (2) the tax would not be a "net income" tax and thus subject to the limitations of P.L. 86-272, a federal statute that limits the reach of state income taxes on out-of-state firms.[38] Congress enacted P.L. 86-272 in 1959 in response to a cluster of Supreme Court opinions that gave states the power to impose net income taxes on an out-of-state business even where the business's only activity in the taxing state was the solicitation of sales.[39] Although the provision was originally intended to be only temporary, it contained no sunset clause and thus continues in effect today, more than a half century later.

Under P.L. 86-272, no state may impose a net income tax on the income from interstate commerce of any person if the only business activities of that person within the State are certain statutorily specified solicitation activities. In effect, P.L. 86-272 carves out for the benefit of certain multistate firms an exemption from state net income taxes similar to that found in *Quill*. As with the *Quill* exemption, the provisions of P.L. 86-272 have the effect of limiting the state's taxing jurisdiction. In the same way states wishing to adopt a broad-based household consumption tax are frustrated by the rule of *Quill*, states wishing to adopt a broad-based net income tax are frustrated by the provisions of P.L. 86-272. The challenge for the Parsky Commission, therefore, was to be able to characterize the BNRT as neither a sales tax (thus avoiding *Quill*) nor an income tax (thus avoiding P.L. 86-272).

Whether the BNRT would be considered a "net income tax" within the meaning of P.L. 86-272 would likely turn on the various types of deductions available under the tax. For example, if the BNRT were to

feature income-tax-like depreciation deductions for capital investments, it would begin to look more like an income tax that would be subject to the limitations of P.L. 86-272. At one point during its deliberations the Commission *was* considering depreciation-like deductions for capital expenditures, including the possibility of a cost recovery regime based on federal law, coupled with an interest payment designed to replicate the effects of expensing. Ultimately, aside from certain transition rules, the BNRT proposal did not include a depreciation deduction—a fact in favor of the inapplicability of P.L. 86-272.

Significantly, however, P.L. 86-272 as currently codified is not the only concern state tax reforms face when designing new business taxes such as the BNRT. Under proposed legislation designed to "modernize" P.L. 86-272, the federal statutory limitation would be extended to *all* forms of business taxes, not just net income taxes. This "Business Activity Tax Simplification Act" (BATSA) has been introduced several times in Congress and is specifically designed to reach taxes such as the Michigan and Ohio levies discussed above, as well as not-yet-enacted taxes such as the BNRT.[40] As BATSA supporters explain, the proposed legislation "ensures that Public Law 86-272 covers *all* business activity taxes, not just net income taxes."[41] In short, states hoping to undertake fundamental tax reform must be attentive to both existing and proposed federal limitations on state taxing power.

### C. FEDERAL STATUTORY CONSTRAINTS —26 U.S.C. §164

There is one additional set of federal statutory "constraints" on state taxing authority that deserves mention. Section 164 of the Internal Revenue Code provides a federal income tax deduction for certain taxes paid to state and local governments. Unlike *Quill* and P.L. 86-272, this provision does not involve an outright ban on the imposition of certain taxes, but rather provides a differential subsidy for different types of taxes. While taxpayers may generally deduct income taxes and both real and personal property taxes paid to states and their political subdivisions, sales taxes are not deductible.[42] Thus, section 164 operates like a "tax system within a tax system" – favoring the adoption of some taxes and discouraging the adoption of others.[43]

## A FEDERAL TAX SUBSIDY

In addition to favoring certain types of taxes over others, section 164 also varies the amount of the federal subsidy depending on the identity of the taxpayer. Taxpayers subject to a high marginal tax rate receive a much larger subsidy than those subject to a lower rate. Depending on the taxpayer's marginal tax rate, the value of the state/local tax subsidy can be quite substantial. For example, a taxpayer with a 35 percent marginal tax rate who incurs $10,000 in state income tax liability will save $3,500 in federal taxes. It is as though the federal government is reimbursing the taxpayer for 35 percent of his payments to state and local governments.

In crafting a state tax system, reformers should generally prefer—all else equal—to adopt a package of taxes that maximizes the value of the federal subsidy made available via section 164. The value of the federal income tax subsidy for state and local taxes is a function of (1) whether the taxpayer itemizes deductions for federal income tax purposes (as the deduction is not available to non-itemizers), (2) whether the taxpayer is subject to the alternative minimum tax (as the deduction is not available under the AMT), (3) the taxpayer's marginal tax rate (as deductions are more valuable for taxpayers subject to higher tax rates), and (4) whether the types of taxes paid are among those for which a deduction is allowed.

## MAXIMIZING THE FEDERAL SUBSIDY

Accordingly, the general strategy for designing a tax system in order to maximize the §164 subsidy should be to rely more on income and property taxes than on sales taxes. In addition, the strategy should concentrate the tax burden on high-bracket itemizers not subject to the AMT. For states with both an income tax and a sales tax, like California, this strategy generally favors the adoption of progressive income taxes or property taxes over retail sales tax.

Again, however, this strategy is complicated to some degree by the effects of the alternative minimum tax. The AMT generally affects high-bracket taxpayers, but very high-income households commonly "blow through" the AMT because they have a greater proportion of their overall income taxed at the 35 percent rate. If the 2001 and 2003 tax cuts expire as scheduled at the beginning in 2011, there will be far fewer AMT taxpayers by virtue of the increase in the ordinary income tax rates. The result will be that the state/local tax deduction will be quite valuable to taxpayers newly liberated from the AMT.

## SUMMARY FOR CALIFORNIA

To summarize, state tax reformers do not have the luxury of simply designing an ideal tax system from scratch. In addition to all the usual pressures influencing tax reform, political and otherwise, the state tax reformer must be attentive to the many constraints imposed by state and federal law. In the case of California, there are several specific and quite restrictive constraints.

First, to the extent that reducing tax volatility is a meta-goal of the tax reform project, reformers will naturally be drawn to solutions that reduce reliance on particularly volatile revenue sources, such as corporate income taxes and personal income taxes on capital gains and stock options. This goal points to a reduced reliance on income taxes in general, and a turn away from progressivity. Second, to the extent that one accepts Proposition 13 as an immutable feature of the Californian fiscal landscape, property taxes are off-limits.

Third, reforms to the retail sales tax are necessarily going to be limited in scope, given the Supreme Court's decision in *Quill*. Fourth, to the extent that new business taxes are envisioned, care must be taken to avoid the strictures of *Quill*, P.L. 86-272, and any pending BATSA-type federal legislation expanding the reach of P.L. 86-272 to a broader range of state business taxes. Litigation over these matters is virtually guaranteed.

Finally, in choosing among different types of taxes and their distribution across income classes, the reformer should be attentive to the benefits of federal income tax deductibility under the Internal Revenue Code. Because these subsidies are concentrated on high-income earners with large state income tax liabilities, there is a built-in tension between the desire to minimize volatility and the desire to maximize the federal subsidy. Maximizing the federal subsidy (subject to the AMT caveat) points toward progressivity. To the extent it is believed that progressivity begats volatility, the tilt is toward regressivity.

This is the Water Torture Cell into which the Parsky Commission was lowered in late 2008 when Governor Schwarzenegger issued the Executive Order establishing the Commission on the Twenty-First Century Economy. In terms of tax reform options, California is heavily shackled with very little freedom of movement. Can it escape from this rickety contraption with a new and improved tax system for the 21st century? The Parsky Commission's

answer, delivered to the Governor in September 2009, was emphatically yes—*but only if* lawmakers would approve the adoption of a new controversial tax—the Business Net Receipts Tax.

## III. THE (ATTEMPTED) ESCAPE: COTCE'S PROPOSED BNRT

The Parsky Commission's final report came in at 425 pages, most of which consisted of actual text of proposed legislation. But its recommendations boiled down to four key reforms: (1) reduce and restructure the personal income tax, (2) eliminate the corporation tax and the franchise minimum tax, (3) eliminate the state general purposes sales tax, and (4) establish a new "Business Net Receipts Tax." The package as a whole shows unmistakable evidence of the various constraints described above.

First, the meta-goal of reducing revenue volatility is addressed head-on via the reduction of PIT rates and the elimination of the corporate income tax. Second, there are no recommendations whatsoever regarding the property tax or any other feature of the state's tax system that would require constitutional reform. Third, the *state* general sales tax is repealed, but local sales taxes are left in place. Finally, a new tax—the BNRT—is proposed to replace the revenue lost from the reduction or elimination of other taxes. The hope of course is that the BNRT will stabilize General Fund revenues while also liberating the state from the various external constraints described in Part II.

The Business Net Receipts Tax made a somewhat mysterious appearance on the COTCE agenda in the middle of 2009. Hearings at UC Davis in early April had focused principally on possible property tax reforms, including the split-roll option discussed above. At the Commission's next meeting, held on June 16 at UCLA, Chairman Parsky asked economist Bob Cline of Ernst & Young to present a preliminary analysis of the BNRT, but the origins of the idea were never revealed.[44] Whatever the idea's origins, the BNRT came to dominate the Commission's discussions over the final three months of its deliberations. It became the centerpiece of the Commission's final recommendations.

### A. BNRT BASICS

The BNRT as proposed by the Parsky Commission was an entirely new tax that would apply to each firm's "net receipts"—defined as a firm's gross revenue minus the amount paid to other firms. The intent was to craft a type of "value-added" tax. Thus, the base was defined so as to reach the two components of value-added, i.e., wages and profits.

Non-deductibility of wages, although unremarkable given the value-added tax framework, prompted some commentators to express concerns about "outsourcing." (More on that point below). The tax would apply to any firm having "economic nexus" with the State of California (i.e., sales above a certain threshold would be a sufficient statutory basis for the imposition of the tax, even if the firm had no physical presence in the state). In addition, the net receipts base of those firms doing business both within and without California would be apportioned by the ratio of the firm's California sales to its nationwide sales (or global sales, in the event of a firm's water's edge election). The tax would apply to all firms without distinction as to entity type.[45]

### B. WHAT IS THE BNRT?

Using the terminology of the academic literature on tax policy and public finance, the BNRT is probably best described as a variation of a subtraction-method value-

added tax. The "value-added tax" is an exceedingly common form of consumption tax used throughout the world. It typically applies at the firm level, meaning that businesses rather than households remit the tax to the government.

In a "subtraction-method" VAT, businesses calculate value-added by subtracting from their gross revenues amounts paid to other firms. This may be contrasted to the "addition-method" VAT where value-added is calculated by aggregating the firm's returns to the various factors of production. Most countries with a value-added tax follow the "credit-invoice" method of collection. Under that method, firms are required to pay VAT on their gross revenues but are entitled to a credit for the amount of VAT paid on business inputs.

### C. DESIGN FLAWS IN THE BNRT

While the BNRT may be regarded as a type of value-added at a broad conceptual level, certain specific features of the proposed tax complicate the picture. What follows is not a comprehensive evaluation of the BNRT's flaws. Rather, a brief review of certain key shortcomings is presented.

**Apportionment vs. Border Tax Adjustments.** First, unlike most value-added taxes, the BNRT as proposed did not feature any border tax adjustments. In the typical European-style credit-invoice VAT, importers pay VAT and exporters have the accumulated VAT paid in the production process rebated to them. These border tax adjustments work to ensure that consumption is taxed on a destination basis—that is, by the jurisdiction where the consumption takes place. Such border tax adjustments are not possible in the U.S. multistate setting as there are no border controls among the states.

For this reason the BNRT relies instead on an apportionment formula for taxing firms that operate in multiple jurisdictions. According to the final COTCE report, a firm operating inside and outside of California would calculate its total "net receipts" and then multiply that figure by a fraction the numerator of which is sales sourced to California and the denominator of which is total sales. This is an interesting and novel design feature of the BNRT. Unfortunately, however, apportionment according to sales is a flawed substitute for border tax adjustments, a point emphasized by a group of tax policy experts commenting on the BNRT proposal in September 2009.[46]

The inadequacy of apportionment as a substitute for border tax adjustments can be seen most clearly in the case of firms exporting goods and services from California to consumers in other states or in other parts of the world. These firms, to the extent of their purchased inputs (which constitute taxable sales to the firm from which the inputs are purchased), will have a BNRT liability embedded in their production process. Because they are price-takers in world markets, however, it is unlikely that they will be able to pass this cost on to their consumers. Thus, with regard to this important segment of the California economy (i.e., the export sector), the BNRT would operate like a pure tax on California production.[47]

**The BNRT as an "Open" or "Naïve" VAT.** In addition to the lack of border tax adjustments, the BNRT also allowed firms to deduct amounts paid to other firms, *even if such firms were not themselves subject to the BNRT*. This was a critical, and arguably fatal, design flaw of the BNRT as proposed, although as discussed below this feature of the proposed tax was probably unavoidable as a legal matter.

Recall that under a subtraction-method VAT firms pay tax on their gross revenues less amounts paid to other firms. One obvious tax-minimization strategy in such a system is to convert non-deductible wage payments to deductible payments to other firms. In deliberations surrounding the Commission's proposals, this was sometimes termed an "outsourcing" problem.

The concern was that because firms would be allowed a deduction for payments to outside independent contractors but not to their own employees, they would "outsource" their labor needs to outside firms. The incentive to pursue this strategy is reduced, perhaps eliminated altogether, to the extent that all other firms are subject to the tax. That is, if every firm is "in the system," there is nothing to be gained by outsourcing wages to other firms. The proposed BNRT did not (and probably could not, as a legal matter) condition deductibility of payments to other firms on inclusion of those payments within the BNRT base. Moreover, the Commission's final report provided a method for ensuring that at least some outsourced payments would not be included in the system via a small business exemption.[48]

In the tax policy literature on the design of value-added taxes, a system that permits firms to deduct payments without an offsetting inclusion is sometimes called a "naïve" or "open" type subtraction-method VAT.[49] Tax scholars examining VAT design alternatives have generally disfavored open-type value-added taxes because of the tax avoidance opportunities available under this model.[50] Unfortunately, despite the clear superiority of a "closed" or "sophisticated" VAT, such an approach would likely have been struck down as unconstitutional.

Up until recently, California followed a similar type of rule in the context of its corporate income tax by allowing corporations to claim the dividends received deduction only to the extent that the corporate shareholder included the dividend in its California taxable income. However, this provision was held to discriminate against interstate commerce, thus violating the Commerce Clause of the federal constitution.[51] The California courts reaching this decision relied on longstanding U.S. Supreme Court precedent that prohibits the conditioning of deductions on payment of taxes to the state.[52] This same case law likely would have been relied upon to strike down any BNRT provision that allowed deductions only to the extent that payee firms were subject to the BNRT. It is hard to fault the Commission for failing to include a design feature that would likely be held unconstitutional. The point here is to emphasize once again the constraints on successful state tax reform. A properly designed subtraction-method value-added tax requires features that, at least under current Supreme Court Commerce Clause jurisprudence, are constitutionally off-limits.

**Tax Avoidance Opportunities under the BRNT.**
Another flaw in the BNRT design concerns the ability of businesses that might otherwise owe the tax to route sales through out-of-state firms so as to avoid the tax. Recall that BNRT liability is determined by multiplying a firm's net receipts, determined on a nationwide (or global) basis, by an apportionment formula scaled to California sales. Under this formulation, a firm will have zero BNRT liability either if it has zero net receipts or zero California sales. Thus, to avoid the tax, any firm expecting to have positive "net receipts" under the BNRT statute should structure its operations so as to ensure that it has little or no California-source sales.

One method of carrying out this strategy would be to interpose an unrelated party, based in a state other than California, to consummate all sales into California.[53] For the sake of illustration, assume that these avoidance-enabling out-of-state firms are Nevada limited liability companies. A Georgia furniture maker, for example, might sell its dining room sets first to a Nevada LLC, which would then complete the sale to the Georgia firm's consumers in California. The Georgia firm would have positive net receipts but zero California sales (and thus zero BNRT liability). The Nevada LLC would have positive California sales but zero net receipts (and thus zero BNRT liability). There would no doubt be costs to accomplishing this strategy, including some service

fee for the Nevada LLC, but experience suggests that taxpayers often prefer paying a small fee to paying a large tax.

One might respond to the possibility of such tax-avoidance strategies by noting that the Franchise Tax Board (FTB) would have the authority to challenge these transactions under its audit and enforcement authority. However, it bears noting that the key to the avoidance technique just described is a transaction between two unrelated out-of-state firms. Whether and how the FTB would be able to effectively police these transactions is unclear.

**The "Deductibility" of the BNRT.** One final feature of the BNRT proposal deserves mention. In support of package of reforms delivered to the Governor, Chairman Parsky drew attention to what had come to be known in the Commission's deliberations as the "federal offset"—i.e., an overall gain of $6.9 billion that would accrue to the state as a result of adopting the BNRT. The claim was that because the BNRT would be deductible for purposes of the federal income tax, a portion of the overall cost of the tax would be shifted to the federal government.[54] While it is true that a firm's BNRT payments would be deductible for federal income tax purposes, it is also the case that any increased revenues from passing on BNRT cost to consumers would be included in those firms' federal taxable income. As a result, to the extent that the BNRT would operate as intended, it is unlikely that there would be any net benefit to taxpayers from the interaction with the federal income tax.[55]

## IV. CONCLUSION: THINKING INSIDE THE BOX

On receipt of the Parsky Commission's final recommendations, Governor Schwarzenegger said, "I asked the commissioners to think outside the box and they certainly did."[56] The paradox of the Governor's statement is that it is both true and absolutely false. As for the truthful part, it cannot be denied that the Commission's Business Net Receipts Tax was indeed a "novel" proposal. Although loosely based on the Michigan Business Tax, the BNRT was both grander in scope and more innovative in design than the MBT. The MBT is a relatively minor supplemental tax in the scheme of Michigan's overall public finances, while the BNRT was designed to replace large swaths of California's existing tax structure. The Parsky Commission deserves credit for its gumption if nothing else.

That said, in the final analysis, it is hard to imagine anyone coming up with an idea like the BNRT other than in the context of the various and peculiar constraints on California tax reform. If the BNRT is the best we can do while accepting these constraints, then perhaps the time has come to rethink the wisdom of those constraints. As for California-specific limitations, the most obvious candidate for reform is Proposition 13.

Whatever the benefits of Proposition 13 as of June 1978, it is not clear that the system devised by Howard Jarvis more than thirty years ago represents "a 21st century tax structure that fits with the state's 21st century economy." If the state truly wishes to modernize its tax system, it must be willing to consider the possibility of *constitutional* reform. While part of that reform would likely involve changes to the state's property tax, equally deserving of attention is

the allocation of fiscal responsibilities between state and local governments. To ignore these structural features of California's fiscal constitution is to rule out the possibility of meaningful tax reform.

With regard to federal restrictions, the state's options are necessarily more limited. Still, California is not powerless to effectuate change in the system of federal limitations on state taxing power. During the 2008-2009 California financial crisis, there was considerable attention devoted to the possibility of some sort of federal "bailout" for the state.[57] To the extent that California's structural deficit persists, as appears to be the case for the foreseeable future, the bailout debate is likely to continue. But somewhere in between the status quo and an explicit federal bailout, there is a middle path of federal reforms liberalizing some of the current restrictions on state taxing power.

The most obvious reform would be explicit federal legislation overruling the Supreme Court's holding in *Quill* regarding the imposition of a use tax collection obligations on out-of-state vendors. California alone cannot effectuate such a change, but it could make greater efforts to bring about this sort of federal reform. More generally, a truly modernized state tax system—especially one that hopes to rely on household consumption taxes—is ultimately going to require a substantial degree of interstate coordination, most likely through regulation by the federal government. Subnational value-added taxes are not entirely infeasible, but their success depends critically on top-down coordination.[58]

In the absence of reforms removing or liberalizing the various limitations and restrictions described above, it is unlikely that California can do much more than muddle through when it comes to changes to its tax system. There are modest improvements that could be made to the state's tax laws. For example, as I have written elsewhere, the state could reduce the volatility of capital gains taxes by simply allowing taxpayers to remit those taxes over a period of years rather than all at once.[59] Other changes, such as repealing the current statutory prohibition on local income taxes, are also worth considering.[60] There is also value in considering changes to the state's retail sales tax, such as reducing the burden on business inputs.

Each of these changes would require only statutory amendments, and could be enacted by a simple majority in both houses of the legislature. But the resulting improvements to the state's tax system would be only marginal. More ambitious goals, such as crafting a 21st century tax system for the state's 21st century economy, require a more fundamental rethinking of the California fiscal constitution.

# END NOTES

1 The quote is found on numerous websites including http://www.houdiniandnate.com/Houdini.html

2 Dan Walters, *State Tax System Fix Likely Doomed*, Sacramento Bee (September 30, 2009).

3 Governor Arnold Schwarzenegger, The Blog, Office of the Governor (October 12, 2009), available at http://gov.ca.gov/index.php?/blog/issue/getting-california-off-the-revenue-rollercoaster/general

4 George Skelton, *California Tax Reform Plan Much Too Bold for Capitol*, Los Angeles Times (October 1, 2009).

5 The idea of a value-added tax is, of course, very familiar. Among alternative forms of value-added taxes, the subtraction-method VAT is generally disfavored (and far less common than the credit-invoice method). As described further below, the uniqueness of the BNRT proposal relates to its use at the subnational level, where multi-jurisdictional issues abound.

6 Executive Order S-15-09 by the Governor of the State of California (available at http://www.gov.ca.gov/executive-order/12921/

7 The Commission's first meeting, held on January 22, 2009, was dominated by a discussion of revenue volatility. The words "volatile" and "volatility" appear in the searchable transcript 107 times, as compared to twelve times for "equity" or "equitable" and nine times for "fair" or "fairness."

8 Elizabeth G. Hill, Legislative Analyst, Revenue Volatitlity in California (January 2005)

9 The relevant constitutional provision is Section 20 of Article XVI of the California Constitution, which establishes the Budget Stabilization Account.

10 *See* Part III infra. *See also* Kirk J. Stark, *Stretch Out Capital Gains to Ease the State's Boom-Bust Cycle*, Sacramento Bee (September 6, 2009).

11 Final Report at 18.

12 Id.

13 Kirk J. Stark, *The Uneasy Case for Extending the Sales Tax to Services*, 30 Florida State University Law Review 435 (2003).

14 Walter Hellerstein, *Florida's Sales Tax on Services*, 41 NAT'L TAX J. 1-18 (1988)

15 Evan Halper and Jordan Rau, *Governor Pushes Hike in Sales Tax, Big Cuts*, Los Angeles Times (November 7, 2008); Kevin Yamamura, *Schwarzenegger: Lower the State's Sales Tax Rate and Apply it to Services Now Untaxed*, Sacramento Bee (August 25, 2010).

16 Transcript of COTCE Hearings, page 41 (January 22, 2009).

17 See, e.g., Remarks of Commission John Cogan, Transcript of COTCE Hearings, page 28 (January 22, 2009): "One of the sources of volatility is the progressivity of the code, tax code. But when we have a progressive tax code, revenues grow faster during a period of economic growth or over the long-term than they do under a – sort of flat tax or a flat consumption tax. Yet under a flat consumption tax you would get a larger growth in the economy, presumably. So our Commission has, I guess, a goal of not raising taxes, so we would like to have some sort of budget-neutral revenue policy or a policy that generates the same amount of revenues over the long-term as the current code but gets rid of the volatility."

18 *See*, e.g., Mark Baldassare, *A California State of Mind: The Conflicted Voter in a Changing World* 47 (2002) ("Proposition 13 has become the 'third rail' of California politics; no elected official or candidate for statewide office dares to touch it."); Peter Schrag, *Paradise Lost: California's Experience, America's Future* 133 (2004) (describing Prop 13 as the "third rail" of California politics—"touch it and you die.").

19 These data are taken from the 2008 federal Census of Governments, Table 1, State and Local Government Finance, which lists California's total state and local government tax revenue for 2008 as $186,014,884,000, consisting of $117,361,976,000 in state taxes and $68,652,908,000 in local taxes.

20 Jerry Nickelsburg, UCLA Anderson Business School, Presentation to the Commission on the Twenty-First Century Economy (February 2009).

21 Id.

22 Transcript of COTCE meeting, UCLA 173 (February 2009).

23 Steven M. Sheffrin, *Economic Aspects of a Split-Roll Property Tax 4* (February 2009), available at http://www.cotce.ca.gov/documents/reports/documents/Economic%20Aspects%20of%20A%20Split.pdf

24 Terri A. Sexton, *Economic Effects of a Split-Roll Property Tax in California* (April 9, 2009), available at http://www.cotce.ca.gov/meetings/testimony/documents/TERRISEXTON-COTCE-4900-Commissionon21stCenturyEconomy.pdf. In her testimony before the Commission, Professor Sexton emphasized that moving to a split-roll tax would principally involved taxing "undervalued parcels of land" and that "to that extent, again, these taxes would fall primarily on land, a fixed input, an immobile input; and it would have very little sort of excess burden or deficiency costs associated with them. It is sort of the Henry George 'tax land' argument.") See Transcript of COTCE Hearings, page 231 (April 9, 2009).

25 George Skelton, *California Tax Reform Plan Much Too Bold for Capitol*, Los Angeles Times (October 1, 2009).

26 Nothing much turns on whether to characterize a particular constraint as "internal" or "external," though it bears noting that state constitutional law, discussed briefly above, might plausibly fit within either category. The Commission *could have* considered constitutional tax reform as part of its mandate, but it chose not to do so.

27 U.S. Constitution, Article VI, Section 1, Clause 2.

28 U.S. Constitution, Article I, Section 8, Clause 3. The "dormant" commerce clause doctrine has its origins in an early U.S. Supreme Court decision called Gibbons v. Ogden 22 U.S. 1 (1824). For a discussion of this early history, *see* Walter Hellerstein, Kirk Stark, John Swain, Joan Youngman, State and Local Taxation: Cases and Materials 104-110 (9th Edition 2009).

29 Quill v. North Dakota, 504 U.S. 298 (1992).

30 McLeod v. J.E. Dilworth Co., 322 U.S. 327 (1944). In his opinion for the majority, Justice Frankfurter concluded that Arkansas (the destination state) could not tax an item purchased in Tennessee (the origin state) because the vendor was "through selling" in Tennessee. Thus, "[f]or Arkansas to impose a tax on such transactions would be to project its powers beyond its boundaries and to tax an interstate transaction."

31 General Trading Co. v. State Tax Commission, 322 U.S. 335 (1944).

32 National Bellas Hess v. Illinois Department of Revenue, 386 U.S. 753 (1967).

33 Michigan Code Section 208.1200(1) (taxpayers with "substantial nexus" include those who "actively solicit" sales in the state and have gross receipts of $350,000 or more sourced to Michigan); Ohio Revenue Code Section 5751.01(G)-(I) (taxpayers with "substantial nexus with this state" include those who have a "bright-line presence," which includes, *inter alia*, taxpayers with "taxable gross receipts" of at least $500,000). Both provisions would subject a taxpayer with gross receipts above the threshold to taxation in the state even if the taxpayer lacks physical presence in the state.

34 Revenue Administration Bulletin 2008-4, Michigan Business Tax Nexus Standards (October 21, 2008); Ohio Department of Taxation Information Release, CAT 2005-02, Commercial Activity Tax: Nexus Standards (September 2005). Indeed, even California has enacted legislation (i.e., SBX3 15, enacted as part of the February 2009 budget deal), incorporating an "economic nexus" standard for its corporate income tax.

**35** The L.L. Bean litigation raises two distinct legal questions: (1) whether the *Quill* decision should be interpreted to apply only to sales/use taxes, and (2) if yes, whether the CAT is a sales/use tax. Unfortunately for the taxpayer, the Ohio Supreme Court decided question (2) in the negative (i.e., determining that the CAT is *not* a sales/use tax) in its 2009 decision in Ohio Grocers Association v. Levin, 123 Ohio St. 3d 303, 2009-Ohio-4872.

**36** Michigan's tax does include a deduction for payments to other firms, but does not generally allow a deduction for payments made to secure services from other firms. For a helpful overview of the Michigan statute, see Michael J. McIntyre and Richard D. Pomp, *Michigan's New Apportioned Value Added Tax*, State Tax Notes, 673, 675-676 (March 2, 2009).

**37** Alan Schenk and Oliver Oldman, Value added tax: a Comparative Approach 2-4 (2007).

**38** P.L. 86-272 has been codified at 15 U.S.C. §§381-384.

**39** Northwestern States Portland Cement v. Minnesota, 358 U.S. 450 (1959).

**40** Marjorie Gell, *Back to the Future: The Hope for Enactment of BATSA Legislation*, State Tax Notes (July 20, 2009).

**41** The Business Activity Tax Simplification Act: Questions and Answers (September 11, 2007), available at http://www.batsa.org/FAQ.pdf

**42** For years 2003-2009 taxpayers were generally allowed to elect to deduct general sales taxes in lieu of deducting income taxes, an option most often beneficial to itemizing taxpayers residing in states without income taxes, like Texas and Florida. This provision expired as of December 31, 2009. The Obama Administration and several members of Congress would like to extend this provision to 2010 and beyond, though legislation effectuating that extension has not yet been enacted.

**43** Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 UCLA L. Rev. 1389, 1411-1425 (2004).

**44** At one point in the discussions, after Chairman Parsky framed the consideration of the proposal in the passive voice (i.e., "The staff has been asked to prepare these packages for analysis."), Commissioner Cogan jokingly inquired, "These babies have no mothers?" Parsky replied, "Well, there's this godfather floating around here; but they have no direct mothers or fathers."*See* Transcript of COTCE Hearings 148 (June 16, 2009).

**45** That is, it would apply to partnerships, LLCs, and sole proprietorships in the same way it would apply to corporations.

**46** Joseph Bankman et al., *Tax Policy Experts Express Views on California's Proposed Tax Plan*, State tax Notes (September 28, 2009).

**47** Id.

**48** COTCE Final Report, page A-5 ("There would be a small business filing threshold set at $500,000 in gross receipts. In addition, net receipts of $250,000 or less would effectively be exempted from the BNRT base though a credit mechanism.").

**49** *Charles Mclure, The Value-Added Tax: Key to Deficit Reduction?* (1987); see also David Weisbach, Does the X-Tax Mark the Spot?, 56 SMU L. REV. 201 (2003).

**50** Itai Grinberg, *Where Credit is Due: Advantages of the Credit-Invoice method for a Partial Replacement VAT*, Tax Law Rev. (2010).

**51** Ceridian Corp. v. FTB, 85 Cal. App. 4th 875 (2000); Farmer Bros. v. FTB, 108 Cal. App. 4th 976 (2003); General Motors v. FTB, 120 Cal. App. 4th 114 (2004).

**52** See, e.g., Fulton Corp. v. Faulkner, 516 U.S. 325 (1996).

**53** The reason for interposing an *unrelated* party is that the proposed BNRT would require firms to use the unitary method and combined reporting, which generally treats affiliated firms as a single integrated business. It may be difficult to police compliance with the unitary method, but this is at least an area in which California tax officials have considerable experience. The point of highlighting tax avoidance transactions involving unrelated parties is that to emphasize the inadequacy of relying on combined reporting to prevent tax avoidance under the BNRT.

**54** Unlike state and local taxes imposed on individuals, taxes imposed on businesses are generally deductible under section 162 of the Internal Revenue Code as an ordinary and necessary business expense.

**55** See Steven M. Sheffrin, *Tax Reform Commissions in the Sweep of California's Fiscal History*, 37 Hastings Constitutional Law Quarterly 661, 680-681 (2010).

**56** COTCE Press Release, *Commission on the 21st Century Economy Issues Recommendations to Modernize, Stabilize & Simplify California's Outdated Tax System* (September 29, 2009).

**57** *See, e.g., California Bailout, Impossible or Inevitable?*, New York TImes (June 21, 2009).

**58** Charles E. McLure, Jr., *Coordinating State Sales Taxes with a Federal VAT: Opportunities, Risks, and Challenges*, State Tax Nots (June 20, 2005).

**59** Kirk J. Stark, *Stretch Out Taxes on Capital Gains to Ease the State's Boom-Bust Cycle*, Sacramento Bee (September 6, 2009).

**60** California Revenue & Taxation Code, Section 17041.5. For a discussion, see Kirk J. Stark, *Proposition 13 as Fiscal Federalism Reform*, in Proposition 13 at 30: The Political and Fiscal Impacts (2009).

9

# CLEAN TECHNOLOGY IN LOS ANGELES:

## IMPROVING THE CITY'S COMPETITIVENESS


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# INTRODUCTION

In an effort to revitalize its economy, protect the environment, and help create new jobs for its residents, the city of Los Angeles' leadership has been actively looking for ways to help make the city a global leader in the research, development, and production of clean technologies. Los Angeles Mayor Antonio Villaraigosa specifically identified the creation of green jobs, attraction of cleantech companies, and the "greening" of the city as top priorities during his second inaugural address. For the purposes of this report, "attraction" indicates the city's ability to foster business formation, retain firms currently located in the Los Angeles region, and capture major firms looking to relocate. "Attraction" should be thought of as making a city more amenable to business.

City officials have identified various assets that they believe have positioned Los Angeles to be a capital of cleantech. For example, Los Angeles is home to the largest public utility in the country, the largest port in the country, and three of the world's top research universities. The city has built on these assets by instituting one of the most aggressive climate action plans of any major city in the U.S. (GREEN LA) and one of the nation's largest proposed solar projects (SOLAR LA).

However, despite current efforts, the city has yet to realize the level of cleantech job activity and business growth that it hopes to reach. Furthermore, increased competition from other major metropolitan areas across the U. S. has made Los Angeles' CleanTech goals even more difficult to achieve.

The objective of this report is twofold. First, the report analyzes the needs of the cleantech industry in order to assess how Los Angeles compares with other U.S. cities that are determined to develop a cleantech cluster. Second, the report identifies and assesses policy options for improving Los Angeles' competitive advantage.

The authors are former UCLA Master of Public Policy students who completed an earlier version of this report in April 2010 as part of their degree program.

To this end, we surveyed twelve competing cities, analyzed common factors that businesses look at when determining where to grow or relocate, assessed Los Angeles' relative strengths and weaknesses with respect to these factors, and recommended short-term and long-term strategies aimed at improving Los Angeles' competitiveness.

## WHAT IS CLEANTECH?

For the purpose of the report, we use the definition provided by the Cleantech Group, a San Francisco-based organization credited with originating the term.[1] According to the Cleantech Group, "cleantech" represents a diverse range of products, services, and processes, all intended to provide superior performance at lower costs, while greatly reducing or eliminating negative ecological impact, and at the same time improving the productive and responsible use of natural resources."[2]

The term "cleantech" does not identify one specific industry; instead, the term is used to encompass a wide variety of energy efficient and renewable technologies that fall within various industries as traditionally classified by the federal government's standard North American Industry Classification System (NAICS). As a result, we rely primarily on private groups like the CleanTech Group to quantify the size of these industries. We also place some emphasis on solar power and electric vehicle manufacturing in consideration of Los Angeles' relative strengths in these cleantech areas.

## LOS ANGELES' KEY COMPETITOR CITIES

We identified twelve key competitor U.S. cities that have unveiled their own aggressive business attraction strategies for cleantech. These cities were also cited as 12 of the top 15 cleantech activity centers in 2009 by Clean Edge, a leading research and publishing firm devoted to the cleantech sector.[3]

**Table 1. LA's Competitor Cities**

| | | |
|---|---|---|
| Austin, TX | Portland, OR | Boston, MA |
| Sacramento, CA | Denver, CO | San Diego, CA |
| Detroit, MI | San Francisco, CA | Houston, TX |
| San Jose, CA | New York, NY | Seattle, WA |

## LOS ANGELES' COMPARATIVE STRENGTHS AND WEAKNESSES

When deciding where to locate, decision makers within companies compare different cities or regions on a range of factors. A thorough literature review revealed a common set of "business placement factors" most frequently assessed by businesses when comparing regions for relocation or expansion.[4] These seven factors are: workforce, land and facilities, business environment, financing and funding, industry clustering, transportation methods, and quality of life.

We measured how Los Angeles and each of its competitors performs on the seven business placement factors by: evaluating metrics from public sources (e.g.

Census Bureau, Bureau of Labor Statistics, Bureau of Economic Analysis), evaluating metrics from private sources (e.g. Kiplinger Research, Clean Edge, Forbes), and surveying each city's economic development programs and incentives available for cleantech firms. We used this information to develop a gap analysis of Los Angeles' comparative strengths and weaknesses, resulting in the following seven summary findings.

## FINDING #1: WORKFORCE

### LOS ANGELES LACKS TARGETED TRAINING AND DEVELOPMENT.

There is a large and diverse manufacturing base in Los Angeles with various supply chain capabilities for the cleantech sector. The manufacturing base is important to the local economy, as evidenced by the fact that the city leads competitors with the highest manufacturing GDP output ($69 billion) and employment base (605,391 workers).[5] Los Angeles also boasts high employment in industries relevant to solar and electric vehicle manufacturing; the City ranks third in semiconductor manufacturing (8,799 workers) below San Jose (29,000) and Austin (12,478) and third in transportation equipment manufacturing (65,996) below Detroit (99,947) and Seattle (86,492).[6]

However, manufacturing employment in Los Angeles has steadily declined over the last several decades, and the majority of Los Angeles' remaining manufacturing jobs are in low-wage and low-skilled sectors, like apparel and food manufacturing.[7] Some higher-skilled manufacturing workers and former workers may have transferable skills for the cleantech sector, but others will need training in order to transition to specialized cleantech manufacturing jobs.

Los Angeles' local workforce development programs and community colleges are developing green job training programs. These programs must be informed by business needs, with consideration towards career ladders with growth potential. Cities such as Portland, New York, Detroit, and San Jose have engaged their business leaders in directed training programs. Furthermore, some competitor cities are providing economic incentives for creating cleantech employment. For example, Boston and Denver have instituted local tax exemptions for new jobs created and San Francisco has exempted cleantech firms from payroll taxes.

## FINDING #2: LAND AND FACILITIES

### LOS ANGELES HAS SIGNIFICANT AMOUNTS OF EXPENSIVE AND VACANT INDUSTRIAL LAND.

Los Angeles' vacancy rate was lowest relative to competitors in late 2009 at 5.6% versus the median 8.1%; however, when comparing the absolute number of square feet of vacant industrial land, Los Angeles has more vacant industrial land than nine of the twelve competing cities.[8] Although not as expensive as land in San Francisco, San Jose, or San Diego, the cost of the industrial space in Los Angeles is still higher than the median cost in its other competing cities. However, the property tax rates in California are lower than in any other state. Acknowledging their high property tax rates, other cities and states have instituted various property tax abatement programs and loans for improvements to industrial facilities.

# FINDING #3: BUSINESS ENVIRONMENT

### LOS ANGELES IS PERCEIVED AS UNFRIENDLY TO BUSINESS.

Businesses perceive Los Angeles as a costly and overly bureaucratic place to conduct business. In 2009, Forbes magazine ranked 200 of the nation's largest metropolitan areas based on their "cost of doing business" and cited Los Angeles as one of the costliest cities with a ranking of 177.[9] According to a separate 2009 survey released by the Los Angeles County Business Federation, 74 percent of business respondents in Los Angeles said the city is unfriendly to their businesses, compared to 44% of respondents in neighboring cities in LA County.[10]

Compared to its competitor cities, Los Angeles also has a substantial lack of business assistance programs, automated online services, and targeted business information. Other cities have developed one-stop shops, expedited permitting, online dynamic mapping applications (with parcels, demographics, and zones), business retention and relocation centers, and economic development websites with online permitting capabilities and summary information—all targeted directly at cleantech firms.

# FINDING #4: FINANCING AND FUNDING

### LOS ANGELES HAS MANY PROGRAMS THAT NEED DIRECTION AND IMPROVEMENT.

Los Angeles has more federal zones, state zones, and redevelopment project areas in industrial areas than its competing cities, but some cities have made a greater effort to market their incentive zones towards cleantech firms. City leadership in Sacramento, for example, has rebranded one of its state enterprise zones as the "Cleantech Enterprise Zone" for this purpose. Competitor cities have also developed detailed economic development programs with loan funds, grants, loan guarantees, tax credits, and bonds that are specific to the needs of these cleantech firms. Los Angeles needs to develop an economic development program and targeted incentives that amplify the importance of cleantech to its economy.

# FINDING #5: INDUSTRY CLUSTERING

### LOS ANGELES' FOUNDATION FOR CLEANTECH INDUSTRY ENGAGEMENT NEEDS TO BE STRENGTHENED.

Clean Edge's "Job Trends 2009" report ranked the Los Angeles region as the second highest U.S. metropolitan area for cleantech job activity, just below the San Francisco Bay Area.[11] This ranking reflects a geographic concentration of cleantech jobs, investments, and patent activity, signaling Los Angeles' potential strength as an industry cluster.

To help foster cleantech industry engagement, Los Angeles has developed initiatives including Cleantech LA, the Cleantech Corridor, and the Cleantech Manufacturing Center, and is currently in the process of developing a cleantech incubator. The city government needs to continue its leadership in these initiatives by facilitating greater interaction with key stakeholders, investors, researchers, and entrepreneurs. Other cities hire cleantech-dedicated staff and play integral roles in mobilizing regional cleantech networks.

# FINDING #6: TRANSPORTATION SYSTEMS

### THE AIRPORT AND PORT INFRASTRUCTURE IN LOS ANGELES IS THE STRONGEST IN THE NATION.

The capacity of the airports and ports in Los Angeles surpass those in all competitor cities. Los Angeles is made accessible because it holds the third most frequented airport in the nation (Los Angeles International) and two additional airports (Burbank Airport and Long Beach Airport).[12] The City is also serviced by the top two U.S. ports in terms of international TEU traffic activity, the Port of Los Angeles and the Port of Long Beach.[13] As a result, Los Angeles has significant advantages for cleantech businesses which require travel and trade. Given this strength, we do not identify specific policy options for the city of Los Angeles in regards to its transportation systems. We recommend that the city government market these assets to its advantage.

# FINDING #7: QUALITY OF LIFE

### IMPROVING THE QUALITY OF LIFE IN LOS ANGELES IS A LONG-TERM, MULTI-LEVEL STRATEGY FOR THE ENTIRE CITY OF LOS ANGELES.

Quality of life is difficult to quantify, but some statistics and rankings indicate how Los Angeles is perceived by those not from the City. Kiplinger's 2009 "Cost of Living" index ranks Los Angeles at a costly 142 on a scale of 200—much higher than the national average of 100 and significantly higher than all competitor regions except San Jose.[14] Other quality of life measures that may factor into a firm's location decisions include Los Angeles' particularly pleasant weather and high average vehicle commute time (second only to New York).[15]

Various city government decisions can influence the region's ability to recruit top talent. Policies addressing issues as varied as K-12 education, congestion relief, transit expansion, affordable housing and access to open space contribute to the perception and attractiveness of Los Angeles. These require a long-term vision of the Los Angeles' mission and strategic goals. We do not identify policy options specific to this factor, but the city government must publicize its attractive assets and continuously work to improve local conditions in order to appeal to all businesses including cleantech.

# STRATEGY FOR ADDRESSING LOS ANGELES' WEAKNESSES

Business location decisions incorporate considerations towards all seven business placement factors. Placement decisions can result from a single, strong economic development policy or several incentives, and the importance of one policy in relation to another may be difficult to assess. In order to adopt incentives strategically, municipalities can address their comparative strengths and weaknesses. Considering our analysis above and the economic development policies we observed in competitor cities, we identified several policy options that would mitigate Los Angeles' key weaknesses. **Table 2** lists the most promising incentives being used in competitor cities to address similar challenges.

# CRITERIA FOR EVALUATING POLICY OPTIONS

We evaluated the policy options based on three criteria: financial impact, ease of implementation, and benefit to firms. These criteria are key to determining meaningful and actionable measures that the city government can adopt to foster Cleantech cluster development. We devised nominal scales for each criterion, and ranked each policy option based on our research, interviews, and our institutional knowledge of the internal political and fiscal climate within the Mayor's Office, City Council, and the City's various departments and agencies.

**Table 2. Policy Options for Los Angeles CleanTech**

| | |
|---|---|
| **Workforce:** | Cleantech Industry Skill Panels |
| **Land & Facilities:** | Property Tax Abatement |
| **Business Environment:** | Cleantech Business Assistance Center<br>Local Purchasing Preference<br>Enhanced Economic Development Website and Online Tools |
| **Financing & Funding:** | Revolving Loan Fund |
| **Industry Clustering:** | Enhanced Regional Cleantech Network<br>Demonstration Projects<br>Cleantech Incubators<br>Cleantech Focused Staff and Expedited Permitting Service |

# DIFFICULTIES EVALUATING INCENTIVE IMPACT

Gauging the effectiveness of a policy option in attracting and retaining cleantech firms is both practical and important. Adopting incentives or programs that have the greatest impact on cleantech economic activity is crucial to the success of Los Angeles' cleantech strategy. However, we discovered that primary quantitative data measuring the effectiveness of incentive programs were either not tracked by city governments or were considered proprietary.

Furthermore, a literature review of commonly offered local economic development incentives revealed numerous conflicting conclusions regarding their effectiveness.[16] Given data constraints and the wide

variation between analyses of economic development programs, we were unable to quantify the specific impact of each incentive on cleantech firm location decision-making and job creation.

It is important to note that the implementation and affordability of a program or policy is crucial to its success. The success or failure of these programs is as dependent on its structure as its implementation. Based on best practices observed in other regions, we provide Los Angeles-specific recommendations for implementation.

# FINANCIAL IMPACT

We used "financial impact" to summarize the costs of required staffing, up-front capital and the source of funding. Options that require significant capital from the General Fund, the CRA/LA, or City department funds may simply be infeasible at the present, even if long-term financial returns are expected. Considering Los Angeles' fiscal situation, we evaluated the anticipated financial impact of each policy option on a scale of "low," "moderate," and "high." The city government's interest is in adopting zero- to low-cost incentives and deflecting or sharing costs with external sources when possible.

We relied on interviews with City staff for cost estimates. We also accounted for costs incurred within a short-term time frame of three fiscal years and considered costs above $150,000 as more significant than those below. The threshold of $150,000 was chosen to reflect the same cutoff point at which many City department initiatives require Council approval.

In general, we value allocations from the General Fund least favorably, followed by contributions from the CRA/LA and City departments, further followed by funding from proprietary departments. Costs to external or private sources are viewed as most favorable. We took both features into account and assigned the values as outlined in the **Table 3**.

**Table 3. Financial Impact Criteria**

| | Expected Costs <$150k | Expected Costs >$150k |
|---|---|---|
| **Funding Sources:** | | |
| General Fund | High Impact | High Impact |
| CRA/LA or City Departments | Moderate Impact | High Impact |
| Proprietary Departments | Low Impact | Moderate Impact |
| Private | Low Impact | Low Impact |

# EASE OF IMPLEMENTATION

Critical to providing reasonable recommendations is an acknowledgement of the ease of implementing a proposed policy option. We measured political feasibility as a function of two factors:

- The authorization needed to adopt an incentive or program; and

- The anticipated political support and opposition the policy is likely to generate.

Many economic development programs offered by cities are funded and administered by City departments, such as the CRA/LA and LADWP. However, the adoption of each policy option requires different levels of authorization. For example, the general manager of the LADWP has the authority and discretion to sign contracts of up to $150,000 without seeking the approval of the LADWP Board of Commissioners.[17] Contracts exceeding that amount are subject to Board approval, and if the expenditure is high enough, City Council approval might be required as well. Typically, expenditures by the LADWP and the Port of Los Angeles in excess of $150,000, and expenditures by the CRA/LA in excess of $50,000, require board approval, which can make policies more difficult to adopt.[18]

However, just because a policy can be authorized by a general manager does not make it politically feasible. Although they are politically appointed, general managers have obligations as chief executives of their department and are often governed by their own charter. Policies that require Council approval can be more difficult, because it can require the support of at least eight out of fifteen members. Therefore, we ranked policy options that only require the Mayor's approval as "easy," those that require a General Manager or Board of Commissioners approval as "moderate," and those that require City Council approval as "difficult."

Political feasibility is also affected by the political will behind a policy. For example, a policy might require City Council approval, which under the previous criterion ranks as politically difficult. However, if there is enough political pressure or support for a policy, the approval of the policy becomes easy. This phenomenon is clearly a difficult criterion to quantify in a standardized approach. We relied on interviews and discussions with our staff throughout City departments to assess the political feasibility behind each policy. Policies that have broad political support or momentum were ranked as "easy." Policies that have some form of political support were ranked as "moderate," and those that we felt have little or no support were ranked as "difficult."

## BENEFIT TO FIRMS

The third criterion for policy evaluation is the benefit experienced by firms. These options vary in the type of direct or indirect impact that it would have on cleantech firms. We categorized the benefit that each incentive would provide to firms as either a "direct financial benefit," a "transaction cost reduction," or an "indirect benefit."

"Direct financial benefits" include: tax reductions, credits, rebates, exemptions, and abatements; fee reductions and abatements; grants; awards; discounted utilities; and financing options including loan funds and bonds. "Transaction cost reductions" lower the costs of doing business not covered under "direct financial benefits" by expediting processing times and connecting businesses with necessary services quickly. "Indirect benefits" strengthen the quality of local businesses and foster regional economies of scale for cluster development. These benefits include strengthened networking opportunities.

# POLICY OPTIONS

## ADDRESSING LA'S WEAKNESS: WORKFORCE

### CLEANTECH INDUSTRY SKILL PANELS

The skills and availability of the local workforce are an important business placement factor for cleantech companies that are considering operating in Los Angeles. Los Angeles needs cleantech industry-specific workforce development programs that are jointly planned between the City's Workforce Investment Board and cleantech businesses. Training programs should be focused on advancing the skills of the city's large manufacturing base by providing direct job paths and career ladders in the cleantech industry. Furthermore, programs should specifically cater to cleantech companies that are growing and/or relocating in Los Angeles. To this end, some competitor cities have instituted industry skill panels—"locally-driven public-private partnerships of business, labor, and education that address immediate or long-term workforce needs for a specific industry."[19]

For example, the city of Portland instituted cleantech industry skill panels that "comprise of a cross section

of companies in particular industries that prioritize occupations necessary for continued growth of the industry and identify the unique training needed to prepare workers for those positions. These panels select the training providers to ensure the classes meet their specific needs."[20] More importantly, such programs leverage the resources outside of the capabilities of the city's workforce centers to fund the training needs of local businesses.

**Financial Impact: Low.** Los Angeles currently offers numerous workforce development and placement programs to its residents. With twenty-one WorkSource Centers, an active Workforce Investment Board (WIB) and Community College District, and millions in ARRA funding, Los Angeles has the infrastructure necessary to make improvements that better target the needs of cleantech businesses.

**Ease of Implementation: Easy to Moderate.** This program requires no additional statute adoption. Reorienting the work of the current training programs would require buy-in from training programs and administrators. The political feasibility of industry skills panels is high because it engages businesses, training programs, unions, and employees in a comprehensive planning process that is meant to benefit all of them.

**Benefit to Firms: Transaction Cost Reduction.** This program would directly benefit businesses; their labor needs would be fulfilled by the reorientation of training programs to their specific requirements. When planning expansions or recruitment, businesses would turn to this vital resource.

# ADDRESSING LA'S WEAKNESS: LAND & FACILITIES

## PROPERTY TAX ABATEMENT

Some competitor cities encourage business location by providing property tax reductions or abatements for certain types of firms. Detroit, for example, offers 50% property tax abatement on real and personal property for industrial and high technology facilities for up to 10 years.[21] In addition, property tax abatement is provided to businesses rehabilitating blighted industrial facilities. For example, New York's Industrial and Commercial Abatement Program "provides abatements for real property taxes for varying periods up to 25 years. Eligible industrial and commercial buildings must be built, modernized, expanded, or otherwise physically improved."[22]

Los Angeles can offer similar property tax abatements for firms within specific industries (i.e., cleantech, high technology, or manufacturing) or in certain regions to encourage rehabilitation of industrial space (i.e., within the designated cleantech Corridor). This is particularly relevant because industrial space is more expensive in Los Angeles than in many of its competitor cities.

**Financial Impact: High.** Property tax reduction may encourage firm location that would otherwise not occur. In these instances, collection of reduced property taxes results in increased revenue that would alternatively remain unrealized. While net returns from this option are difficult to assess, we rate property tax abatement as having a high financial impact, since the City will directly bear the costs of the policy.[23]

**Ease of Implementation: Difficult.** The adoption process of property tax abatement is difficult and the political feasibility is low. First, it would need to be approved by the state. The abatement of these taxes would impact the general fund of the City and state during a time where both budgets are projecting near-record deficits. Furthermore, this policy both ignores and offends the needs of traditional manufacturers that are struggling to retain workers and keep their businesses.

**Benefit to Firms: Direct Financial Benefit.** This would provide a significant benefit to firms who will have one less cost to consider in their budget.

# ADDRESSING LA'S WEAKNESS: BUSINESS ENVIRONMENT

## CLEANTECH BUSINESS ASSISTANCE CENTER

Business assistance centers are physical spaces that provide small business owners and entrepreneurs with a variety of business development resources, such as technical consulting services, access to computers, conference rooms, and other space and equipment. City leadership could develop a center catered specifically to cleantech firms and locate branches of the center in the industrial hubs of the city. For example, New York City's Industrial Development Agency (NCIDA) provides and files incentive and tax applications for landowners in industrial areas; further, NCIDA recently began expanding this assistance to developers of rental space.[24] Furthermore, New York opened one of its NYC Business Solution Centers in an "industrial business zone" with "dedicated counselors for industrial businesses…[who] help industrial companies access incentives, comply with regulations, and take advantage of business opportunities [with the City]."[25] Placing a cleantech business assistance center in the Cleantech Corridor will provide easy access to companies placing their businesses in this zone, and ensure to these companies that the City leadership is dedicated to the industry.

**Financial Impact: High.** Development of a new cleantech-specific small business assistance center would require significant startup costs for staff, equipment, and building space. We expect costs to exceed $150,000, though costs may decline in the long-term. A center of this sort would likely be created and funded by the CRA/LA or a City department like the Community Development Department. Therefore, we ranked this option high in terms of financial impact.

**Ease of Implementation: Easy to Moderate.** As mentioned earlier, the cleantech business assistance center would most likely be funded and administered by either the LADWP or CRA/LA, with costs greater than $150,000. Therefore, this option received a ranking of moderate because it would require board and City Council approval. However, as stated in his second inaugural address, helping small businesses is one of the Mayor's top priorities, and members of his staff have been actively exploring this option over the past year.[26] City Council has also expressed support for small business assistance. This option ranked easy in terms of political support.

**Benefit to Firms: Transaction Cost Reduction.** This option provides a transaction cost reduction to firms, because it provides them with access to consulting services, space, and equipment that they would otherwise have to pay for. The city of Austin, Texas, recently won a leading award for being the best place in the country for small businesses, primarily because of its Small Business Solutions Center.[27] Within the first year, the center generated 2,000 visits, 2,500 hours of use, and resulted in $2.6M in additional revenue for businesses who used the facility.[28] This option improves the local business environment and lowers the barriers to growth, therefore reducing transaction cost.

## LOCAL PURCHASING PREFERENCE

According to the Los Angeles City Charter, the city government is required to accept the lowest cost bid when procuring goods and services. The city government can act as a major driving force in its local economy by adopting a local purchasing preference that gives local firms a slight advantage on winning contracts. Competitor cities have instituted a 5% or 10% boost on the ranking of a local business's bid on City contracts. For cleantech companies, locating in Los Angeles would mean that they would immediately receive a price preference on the billions of dollars of cleantech procurement expected to come from DWP.

**Financial Impact: Moderate to High.** Local purchasing preferences pose costs as the city government pays more than they otherwise would for services, with the expectation that local investments will result in long-term local benefits. Implementation of a local purchasing preference would likely result in costs well above $150,000 collectively, though actual costs are largely dependent on the details of the program design and the size of the percentage preference. We therefore ranked this program as moderate to high in terms of financial impact.

**Ease of Implementation: Moderate.** A similar policy has been approved by the General Manager of LADWP and his Board of Commissioners and supported by the Mayor's Office.[29] However, it has since been passed to City Council where the policy has remained for months.[30] Therefore, we ranked the option as difficult in terms of the adoption process criterion. The high feasibility yet cumbersome adoption process render this policy as moderate to implement.

**Benefit to Firms: Transaction Cost Reduction.** This option would directly impact local firms by ensuring preferred access to their local market. This somewhat counteracts the higher cost of doing business in Los Angeles.

## ENHANCED ECONOMIC DEVELOPMENT WEBSITE AND ONLINE TOOLS

At this writing, the City's website offers limited information on business assistance, incentives, and regional assets. A single page on the Mayor's Office website outlines cleantech goals and four local assets, but fails to provide the level of information necessary for cleantech business owners and location specialists to estimate a return-on-investment calculation.[31] In addition, misdirected links are found throughout the Economic Development website, including the link for business incentive programs. The city government can enhance its website, along with the website of its departments and agencies, to be more interactive with the end-user; furthermore, it can target the information to businesses—specifically cleantech businesses—in a streamlined fashion.

A robust website is critical to economic development marketing for a variety of reasons. In its July 2008 survey, Development Counsellors International found that corporate executives responsible for site selection cited information on available incentives as most important (82%), followed by demographic information (73%) and a property directory (49%).[32] Further, when preparing quantitative and qualitative assessments for site selection, companies may analyze insufficient or incomplete data when information on a region is not readily available; this can skew their return-on-investment (ROI) analysis.[33] Providing clear information about Los Angeles' advantages and demographics will ensure that companies base their site selection analyses on accurate data.

Finally, many of Los Angeles' incentives are available in State Enterprise and Federal Empowerment Zones. The Public Policy Institute of California recently found that while the effect of State Enterprise Zones appeared to be insignificant in general, small benefits could be observed when cities marketed programs well and provided GIS map renderings of the zones.[34]

Like many other cities have done, Los Angeles can use website materials geared towards cleantech to better advertise these existing zone incentives.

Los Angeles could also address multiple concerns regarding business environment in a single website. Los Angeles would be best served by compiling a comprehensive list or search tool of its available business incentives, zones, and parcels. Integration with web-based, interactive GIS mapping should be considered in conjunction with website development. Finally, a website could include a separate section geared specifically towards cleantech firm owners highlighting Los Angeles' relative strengths.

**Financial Impact: Low.** Costs of this project would be primarily incurred in the short-term during website development, with costs subsiding for maintenance of the website in the long-term. The development and subsequent launch of the website could take place in under two years within a broad pricing range, depending on the additions or exclusions of complex web applications such as GIS-based interactive mapping software. Costs would likely amount to less than $150,000. This option would have a low financial impact.

**Ease of Implementation: Easy.** Simple website expansion could be managed by a designated web design staff member while a more substantial website overhaul could easily be contracted to an external web design firm. The project could thus be initiated at the discretion of the Mayor. Furthermore, the lack of coordinated information on the City's current economic development website, "Business Solutions", has been recognized by the Mayor's staff and City departments as antiquated.[35] Therefore, we believe there is a great deal of support for this policy option.

**Benefit to Firms: Indirect Benefit.** The primary purpose of an enhanced economic development website is to provide clear and accessible information. Though specific financial incentives and streamlined services are not necessarily enhanced through this option, firms are provided with the necessary data to make informed business location decisions and connect with resources relevant to cluster development, networking, and financing.

# ADDRESSING LA'S WEAKNESS: FINANCING AND FUNDING

## REVOLVING LOAN FUND

Revolving loan funds are typically low-interest, gap-financing loans offered by municipalities to new ventures and small businesses so they can rehabilitate or purchase buildings or equipment. Several of the competitor cities—including Denver, Detroit, New York, and San Diego—offered revolving loan funds to businesses regardless of their industry. Many of the loan funds witnessed in other cities offer 25-year repayment periods to cleantech companies.

LADWP has maintained an annual $5 million Utility Infrastructure Revolving Loan program since 2001.[36] Qualified businesses can use the funds to pay for equipment or building upgrades that improve their energy efficiency. In comparison to other cities' programs, LADWP's program is relatively limited in its scope, as it pays for utility-related costs instead of any operating costs or needs. Also, the program "has been undersubscribed since its creation in 2001… it funded a total $6.7 million in loans in its seven-year history and only roughly $1.2 million in loans in the past three years."[37]

**Financial Impact: Moderate.** Establishing a new revolving loan fund typically requires several million dollars in initial lending capital. Loan funds often receive their initial funds from a variety of public and private sources, including federal departments, state appropriations, and private foundations.[38] Pennsylvania established its new Green Energy Revolving Loan Fund with $48 million, including a $12 million federal award, and partnered with an investment firm to administer the fund.[39] If Los Angeles is able to pool external funds in a similar manner, administration of the fund would result in low financial impact. Erring on the side of caution, we ranked this option as moderate under the assumption that City proprietary departments will need to contribute some startup capital for the fund.

**Ease of Implementation: Moderate.** Because this program would cost more than $150,000, it would need to be approved by the general manager of the LADWP and its board of commissioners. However, this policy ranked high in terms of political feasibility because both the Mayor's Office and the general manager of the LADWP are aggressively pursuing this option.[40]

**Benefit to Firms: Direct Financial Benefit.** This program would directly benefit firms because they would be able to borrow money at below-market rates.

# ADDRESSING LA'S WEAKNESS: INDUSTRY CLUSTERING

## ENHANCED PARTNERSHIP WITH REGIONAL CLEANTECH NETWORK

A strong regional network of cleantech stakeholders is a key aspect of the development of a successful industry cluster. Cleantech specific groups in San Diego, New York, Seattle, and Oregon have worked to establish and strengthen their respective regions' clean technology advantages. These organizations vary in size and scope but have had success in marketing their regions to businesses and advocating for cleantech supportive policies and projects. In particular, the CleanTECH San Diego network is recognized as having elevated the level of intraregional CleanTech collaboration.[41]

CleanTech LA is an established partnership among leaders in academia, business, and government in Los Angeles. Incorporating CleanTech LA as an independent 501(c)3 nonprofit and expanding the membership of the board directly into the venture capital community would strengthen the reach of the organization and bridge a gap in CleanTech LA's leadership.

**Financial Impact: Low.** Local law firms have expressed interest in providing *pro bono* services for incorporating CleanTech LA. Limited mayoral and departmental staff time would be necessary for the successful development of the nonprofit, posing few direct costs and no predicted impact on City funds.

**Ease of Implementation: Easy.** This policy option would require the approval of CleanTech LA's member organizations. Fortunately, there is widespread

support among members for its transition into an independent non-profit.[42]

**Benefit to Firms: Transaction Cost Reduction.** Businesses benefit from a stronger CleanTech LA as the organization would lower barriers to entry in the market and provide a virtual and physical space for intra-sectoral collaboration. This would allow CleanTech LA to become a resource for businesses regarding incentives, investors, and network development.

## DEMONSTRATION PROJECTS

Cleantech firms often request demonstration projects because the industry is relatively new with nascent and often time-intensive products. Many consumers, including the LADWP and the city of Los Angeles, are hesitant to purchase new technologies unless they have been tested or have reached a critical mass. Demonstration projects, therefore, create opportunities for companies and customers to test these new products.

**Financial Impact: Low.** In many cases, demonstration projects are financed by participating firms themselves. Products are donated to a city, whose primary role is to test the performance and quality of the product, and then provide feedback to the firm. However, smaller firms may require public financing for demonstration projects. Though these projects may require multiple sources of capital, demonstration project financing options are varied and flexible.

Some regions have undertaken demonstration projects that require additional funding pools. Oregon, for example, launched a Solar Highway demonstration project financed through a third-party and operated by the local utility company.[43]

**Ease of Implementation: Easy.** Because of Los Angeles' current financial situation, we believe the city government would most likely pursue a program that places minimal cost to the City in the short-term. Therefore, in most cases, the Mayor could authorize demonstration projects via a memorandum of understanding.

**Benefit to Firms: Transaction Cost Reduction.** Although cleantech firms will not directly increase their revenues through this program, firms benefit from having the city government publicize their product, and by receiving feedback on their product's performance. If the trial is successful, it also increases the likelihood of the City purchasing the product in the future.

## CLEANTECH INCUBATORS

Incubators provide a space for the development of business and technology by offering office space at a discounted rate, providing access to laboratories and researchers, and linking the resident companies to investors and consultants. Furthermore, incubators connect entrepreneurs to each other, thereby strengthening the local business network and Los Angeles' ability to retain any businesses that emerge from the incubator.

The collaborative and supportive nature of an incubator results in nearly 90 percent of program graduates remaining in business.[44] Incubators are proven to result in up to twenty times more jobs than other government-supported business development programs.[45] Los Angeles can look to many models of success when developing regional incubators—including MaRS in Toronto, the Clean Tech Center in Syracuse, and the Environmental Business Cluster in San Jose.[46]

**Financial Impact: Moderate to High.** The construction and operation of a cleantech incubator requires significant upfront capital as well as an ongoing funding stream. The project will undoubtedly cost more than $150,000. Collaboration between the LADWP, CRA/LA, and a private operator can fund the project.[47] Regardless of its expected high rate of return on investment, we expect the financial impact

on departments to be moderate to high.

**Ease of Implementation: Easy.** Any incubator relying upon CRA/LA or LADWP expenditures of over $150,000 would need to go before the department's board of commissioners and City Council, making the process of its adoption moderately cumbersome. That said, anticipated political support is high and the project has thus far moved forward without significant roadblocks.[48]

**Benefit to Firms: Transaction Cost Reduction.** Although direct financing would not come from the incubators themselves, they often serve as a center of venture capital activity and facilitate a marketplace of intellectual exchange. Businesses that are admitted into the incubator would benefit in the short term and be more likely to thrive and create jobs in the long term.

### CLEANTECH FOCUSED STAFF AND EXPEDITED PERMITTING SERVICE

Many cities pursuing cleantech firms have consolidated their business permitting processes into online-only systems and "one-stop" shops. The relatively cumbersome business permitting process in Los Angeles is an outlier when compared to competing cities. The proposed "12-to-2" process, which would consolidate the business permitting process in Los Angeles from twelve City departments to two, would improve the City's competitiveness, but the delay in its implementation places Los Angeles behind the pack.

Furthermore, several cities, including our intrastate competitors, have dedicated City staff to cleantech business attraction. For example, San Jose's Clean Tech Strategist is credited with developing the City's successful fifteen-year green vision and managing the attraction of more than fifty cleantech firms.[49] Cleantech dedicated staff provides both a clear connection from the business community to the city government and a point-person within the City to serve as a resource and advocate for cleantech-related issues.

**Financial Impact: Low.** The cost of allocating staff to a cleantech specific role depends widely upon the size of the team and seniority of the staff member(s) assigned to this sector. Competitor cities have not created full departments, so it is unlikely that Los Angeles would need to do so. Given the current hiring freeze, it is more likely that current staff could be transitioned to this role at little or no additional cost, resulting in low financial impact to the City.

**Ease of Implementation: Moderate.** The expedited processing of cleantech (and other) business permits is a more difficult adoption and delivery process, but the City's political leadership is firmly behind the nascent "12-to-2" plan. Therefore, this option ranked as moderate in implementation.

**Benefit to Firms: Transaction Cost Reduction.** The effective implementation of the "12-to-2" expedited permitting process would directly lower transaction costs for businesses and provide increased transparency and speed in the review of their submissions.

# A MENU OF VARIED OPTIONS

The following table summarizes the policy options as ranked above, sorted by financial impact:

**Table 4. Ranked Policy Options For Cleantech Economic Development**

| | Financial Impact | Ease Of Implementation | Benefit To Firms |
|---|---|---|---|
| **Policy Options** | | | |
| Demonstration Projects | Low | Easy | Transaction Cost |
| Reduction | | | |
| Enhanced Cleantech LA | Low | Easy | Transaction Cost |
| Reduction | | | |
| Enhanced Economic Development Website | Low | Easy | Indirect Benefit |
| Industry Skill Panel | Low | Easy To Moderate | Transaction Cost Reduction |
| Cleantech Staff & Expedited Permitting Reduction | Low | Moderate | Transaction Cost |
| Revolving Loan Fund | Moderate | Moderate | Direct Financial |
| Benefit | | | |
| Incubator | Moderate To High | Easy | Transaction Cost |
| Reduction | | | |
| Local Purchasing Preference | Moderate To High | Moderate | Transaction Cost Reduction |
| Cleantech Business Assistance Center Reduction | High | Easy To Moderate | Transaction Cost |
| Property Tax Abatement | High | Difficult | Direct Financial Benefit |

There is no silver bullet for cleantech cluster development. Rather, there is a varied menu of policies and programs that would make Los Angeles a more attractive site for cleantech firms. Mayor Villaraigosa's verbal commitments to the industry need to be strengthened by the implementation of some of these policies and the subsequent allocation of staff and financial resources.

Our analysis reveals that these ten policy options can vary in their cost, feasibility, and benefit to firms. They can also vary in their effect on cleantech business attraction and job creation because proper design, implementation, and funding are essential to their success. These programs need to be designed specifically for cleantech companies and marketed accordingly. Cleantech firms that are already located in Los Angeles should be included in the development of these programs as well; strengthening any existing cluster will create benefits for additional firms to locate within the city. The greatest successes witnessed in other cities occurred when conventional economic development tools were developed and targeted specifically for the cleantech sector—both in their policy design and their outreach.

We did not create a forced ranking of these options due to the lack of commonly accepted measures for business attraction. For Los Angeles to become a hub of cleantech, it needs to adopt a suite of these policies. Given the current budget deficits that the City is experiencing, we recommend short-term and long-term policy adoption strategies. In the short term, Los Angeles should immediately implement cleantech industry skill panels, an enhanced economic development website, strengthened regional cleantech partnerships, and a demonstration project policy; these could all be implemented quickly and at low cost. Given the great successes witnessed by incubators, the long lead-time needed to develop the space, and the current momentum of the CRA/LA's partnership with DWP, the plans for the cleantech incubator should also be prioritized, supported, and funded in the short term. The incubator, though higher cost, will benefit from the presence of various funding sources because it will provide access to key stakeholders and investors.

The cleantech business assistance center, local purchasing preference, property tax abatement, revolving loan fund, and cleantech staff members and expedited permitting would greatly affect the

development of a genuine cleantech cluster in the long term. However, these programs are more costly to implement. The city government can begin positioning its resources for these programs by housing the business assistance center at the incubator, by lobbying City Council to pass LADWP's current proposal for the local purchasing preference, and by prioritizing the "12-to-2" business permitting program.

## CONCLUSION: THE PROSPECTS FOR A LOS ANGELES CLEANTECH CLUSTER

In this report, we identified seven key factors for business location that cleantech companies evaluate when selecting a site location. We evaluated the city of Los Angeles' strengths and weaknesses on these factors in comparison to twelve competitor cities with similar cleantech attraction goals. This evaluation includes standardized measures, rankings, and a comprehensive review of the economic development programs currently employed by Los Angeles' competitors.

Our comparison uncovered strong potential for cleantech growth in the City, as Los Angeles offers strengths in manufacturing, industrial space, and a large, skilled workforce base. However, the City faces enormous challenges in overcoming a reputation of business unfriendliness. Furthermore, many of Los Angeles' economic development programs lack the sophisticated marketing towards industry-specific needs that other cities incorporate throughout their business assistance strategies.

In order to increase Los Angeles' general attractiveness to cleantech business owners, we drew examples of common economic development programs being used in other cities that Los Angeles currently does not offer. We cited ten of these policy options and evaluated them according to their estimated financial impacts, ease of implementation, and benefit to firms. We offer these options for the city of Los Angeles to adopt according to their needs at a given time. From our analysis, the following programs should be implemented immediately: cleantech industry skill panels, a cleantech incubator, an enhanced website, partnerships with regional cleantech networks, and demonstration projects.

Long-term success of the cleantech economic development strategy relies on the city government's ability to foster a true system of interactive firms with strong local entrepreneurship, supply chain linkages, and industry networks. Lessons from cluster theory teach us that it is exceedingly difficult to predict the site of the next industry agglomeration. However, Los Angeles should continuously work to promote development of its burgeoning clusters by aggressively targeting cleantech, working closely with firm leaders, and encouraging industry collaboration. There may not be a silver bullet, but there is a silver lining.

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